# **Appraisal Standards Board**



September 7, 2004

Technical Director
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RE: Exposure Draft of Proposed Statement of Financial Accounting Standards: Fair Value Measurements

Thank you for this opportunity to comment on the Exposure Draft of the proposed Statement of Financial Accounting Standards.

We applaud your effort on this Exposure Draft for two reasons. One, it will be a tremendous help in clarifying the intent of the Financial Accounting Standards Board ("FASB") in the interpretation of the definition of Fair Value. Second, the specific contents of the Exposure Draft are, for the most part, an excellent blend of accounting and valuation concepts and terminology.

As the body charged with the promulgation of the *Uniform Standards of Professional Appraisal Practice* ("USPAP"), the Appraisal Standards Board ("ASB") of The Appraisal Foundation issues Exposure Drafts of proposed changes as the need arises. We understand the importance of public exposure of proposed changes, and we appreciate the opportunity to provide comment on the proposed Statement of Financial Accounting Standards regarding Fair Value measurements. If you are not familiar with USPAP, it provides professional standards for the valuation of real property, tangible personal property and intangible property including business equity. USPAP reflects the current standards of the appraisal profession.

Because we are writing to address matters specifically from the perspective of the contents of USPAP, our comments are limited to issues directly addressed in USPAP. Although USPAP requires appraisers to "be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal," our comments will not delve too deeply into those specific "recognized methods and techniques" because they are not specifically addressed in USPAP. USPAP establishes the standards of the valuation profession and leaves the detailed discussion of methods and techniques and their proper application to other documents.

We first address certain items from the list of issues you noted in your Notice for Recipients of the Exposure Draft. This is followed by general comments.

#### Issue 1: Definition of Fair Value:

In paragraph C27, the document discusses the Interaction between Fair Value and Fair Market Value. It states, "The Board believes that the measurement objectives embodied in the definitions are essentially the same." This is a very helpful statement. We have looked for any points in the proposed definition of Fair Value that might benefit from clarification.

USPAP does not define Fair Value, Fair Market Value, or any other type of value. However, USPAP does specify the concepts that are to be covered in any definition of "Market Value" that is used by an appraiser. Market Value is the term used most often in the valuation of real property. As noted in paragraph 37, IRS Revenue Ruling 59-60 defines Fair Market Value. When operating under this IRS Revenue Ruling, real property appraisers generally interpret the IRS definition to be equivalent to that of Market Value. Therefore, the USPAP points regarding Market Value definitions are pertinent to this discussion.

USPAP identifies certain concepts that are included in any market value definition. Market Value:

- presumes the transfer of a property
- requires an effective date of the presumed transfer (a specific date the presumed transfer is to have occurred)
- includes specific conditions under which the transfer is presumed to have occurred, as specified

The "specific conditions" referenced in the last bullet point should always address certain factors. Quoting from USPAP:

"The conditions included in market value definitions establish market perspectives for development of the opinion. These conditions may vary from definition to definition but generally fall into three categories:

- 1. the relationship, knowledge, and motivation of the parties (i.e., seller and buyer);
- 2. the terms of sale (e.g., cash, cash equivalent, or other terms); and
- 3. the conditions of sale (e.g., exposure in a competitive market for a reasonable time prior to sale)."

All the items above appear to be addressed in the proposed definition of Fair Value with the following exceptions.

First, the proposed Fair Value definition addresses the valuation date by saying a "current transaction." It is generally understood that value opinions relate to a particular date because the value of a property may be different on one date from what it would be on

another date. USPAP calls this date of value the "effective date." It may be true that most value opinions performed for accounting purposes have an effective date as close as possible to the date the valuation work is being performed; a current date. However, in certain cases, the effective date is likely to be something else. For example, SFAS 141 requires the valuation to be done with an effective date equal to the transaction date on which the business combination occurred. That transaction date could be significantly earlier than the date the valuation is being performed. Therefore, we recommend that the proposed definition be adjusted to allow for something other than a "current" date.

Second, item #2 in the USPAP Market Value concepts addresses the terms of sale for any presumed transfer. This brings up the issue as to whether Fair Value is measured in terms of cash (cash equivalent) or not. Some actual transactions occur at "prices" that reflect non-market financing, or have other features that suggest that the price quoted may not be a cash-equivalent price. We would assume it is your intent to deal with cash-equivalent Fair Value, but recommend it be clarified in one of your explanatory comments.

# Issue #4: Valuation Premise

- 1. Your discussion generally deals well with the issue of in-use versus in-exchange. The first sentence in this section states "A valuation premise specifies the condition and location of many assets, including whether assets are installed or integrated with other assets (that is, configured for use by an entity.)" It may be helpful to reword this somewhat with regard to the following two items:
  - a. First, we recommend adding the phrase "certain elements regarding" after the word "specifies" in this sentence. Use of the terms "condition" and "location" to describe the issues covered in a "premise" of value may be confusing. As the paragraph continues, the entire focus is on whether or not the asset is installed and/or configured for use by an entity. Example 3 of Appendix B uses the example of an asset being on the loading dock (in-exchange) versus installed (in-use). While the first sentence is technically correct in stating that these are elements of "condition" and "location," these terms have much more broad interpretation in valuation. There are many issues traditionally associated with "condition" and "location" that have nothing to do with the premise of value but that significantly impact the value of an asset. For example, the wear and tear on a particular piece of equipment is an element of "condition," but has nothing to do with the "premise." The value conclusion may reflect the existing level of wear and tear, whether dealing with an in-use or in-exchange premise of value. Also, the location of assets impacts their value in many ways. It is, of course, one of the major influences of the value of real property. As another example, the geographic region in which a company operates may influence its value, just as it may influence the value of tangible personal property. You may want to clarify the first sentence. It seems that the only "condition" you are addressing is whether the equipment is configured for use and the only "location" you reference is whether the equipment is on the loading dock.

- b. Second, the discussion of valuation premise in Paragraph 13 as well as in Example 3 deals only with two premises; in-use and in-exchange. There are other valuation premises, such as orderly liquidation. You may want to recognize that various premises exist and clarify that this Statement is only dealing with the in-use and in-exchange premises.
- 2. As another point on this section, your discussion in Paragraph 13 and Example 3 seem to deal with machinery and equipment. The premise of in-use versus in-exchange can also have a significant impact on the value of real property. Because this is often a misunderstood concept in the area of real property, much benefit would be gained by a specific discussion and/or examples of this matter as it relates to real property. The issue may also arise in the valuation of intangible assets.

# Issue 5: Fair Value Hierarchy

Professional appraisers have a responsibility to provide credible services, and this requires proper identification of the scope of work. Therefore, clarity in this section of the proposed Statement is key.

- 1. While the conditions in which to use a Level 1 Estimate seems to be clearly differentiated from the conditions that indicate use of Level 2 or Level 3 Estimates, additional clarification would be very helpful regarding the difference between use of a Level 2 Estimate rather than a Level 3 Estimate. This clarification would focus on what is meant by "objectively determinable" and may be better provided by a series of examples rather than additional description in paragraphs. For sufficient clarity, the examples should provide one case that would be interpreted as Level 2 and one case that would be interpreted as Level 3, with different examples for each major type of asset; business equity, real property, tangible personal property, and intangible personal property.
- 2. Paragraph 21 states that "... fair value shall be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort." We suggest that a phrase be added to this sentence "and only when the technique is determined to be applicable." While it is a requirement that all three approaches be "considered" for use in a given valuation, it is common that one or more approach(es) may not be "applicable" in a given valuation. The way this sentence is worded, it seems to indicate that all approaches must be applied, even if they are not expected to impact the final value conclusion. Language to address this matter would make this sentence consistent with the first sentence of paragraph 22, which recognizes the need for "judgment in the selection and application of valuation techniques and relevant inputs."

- 3. The intent of the second sentence in paragraph 22 is unclear to us. "If information necessary to apply multiple valuation techniques is not available without undue cost and effort, the valuation technique that best approximates what an exchange price would be in the circumstance shall be used." It implies that at least one valuation technique must be used, no matter what the cost and effort. Also, it seems to mix one measuring device (cost and effort) with another measuring device (the valuation technique that best approximates what an exchange price would be). What if the valuation technique that best approximates what an exchange price would be is also the most costly one? What if the entity still believeS this one technique would require "undue cost and effort?"
- 4. Under USPAP, it is the appraiser's responsibility to determine which valuation approaches and methods are applicable in a given valuation assignment. Also, it is the appraiser's responsibility to determine when the scope of work proposed by a potential client becomes insufficient to provide a credible opinion of value for a particular intended use (in this case, financial reporting). It is easy to imagine a situation in which the entity asks the appraiser to prepare a value based only on one technique (and specifies what that technique will be) because of cost considerations, but the appraiser does not believe that the use of that technique is sufficient to provide a credible opinion for financial reporting purposes. The cost of the valuation should not be the determining factor. Under USPAP, the manner in which an appraiser determines an appropriate scope of work is based on "1) expectations of participants in the market for the same or similar appraisal services; and 2) what the appraiser's peers' actions would be in performing the same or a similar assignment in compliance with USPAP." It goes on to say that the "An appraiser must have sound reasons in support of the scope of work decision . . ."

Additionally, USPAP requires that the appraiser provide the "reason for excluding any of the usual valuation approaches" in the appraisal report.

## Issue 6: Level 1 Reference Market

Is the concept of Level 1 Estimates intended to apply to assets other than marketable securities? Level 1 contains reference to "identical" assets and that no adjustment is to be made to the quoted prices. Companies with used equipment have "immediate access" to the market in which used equipment is bought and sold. However, adjustments would still be necessary for differences in condition between one specific piece of equipment and another one with the same model number and manufactured and sold in the same year, but that is in very different condition. We assume this is a Level 2 or 3 estimate.

## Issue 9: Level 3 Estimates

1. Clarification of the topic of paragraph 23 would be helpful. Is this paragraph discussing reasons to adjust quoted prices for similar assets to make them applicable to the subject asset? If so, many items seem to be omitted from the list provided, such as the age and condition of a tangible asset, the geographic location of real property, the relative risk of business equities, whether a business equity value is on a control or minority basis, as just a very few examples.

USPAP requires that the appraiser "identify the characteristics of the [subject] property that are relevant to the type and definition of value and intended use of the appraisal.." including "its location and physical, legal, and economic attributes" and "whether the subject property is a fractional interest, physical segment, or partial holding." These factors have a major impact on value conclusions.

To deal with some of these issues, we suggest an amendment to part "f" of paragraph 23 similar to the following:

A price might need to be adjusted for differences in the unit of account, the condition, or location of the asset, or to reflect the appropriate valuation premise or other differences between the asset that was purchased in the transaction and the subject asset.

We realize your use of the phrase "condition or location of the asset" may be intended to address only those matters discussed in paragraph 13, but suggest that there should be a more broad interpretation of the terms.

- 2. Part "a" in paragraph 23 lists certain things that should be considered in determining whether a price is sufficiently current for use as a Level 1 or Level 2 estimate. It should be noted that valuation practice typically allows only the consideration of events that occur prior to the effective date of the valuation or were reasonably foreseeable as of the effective date. Since some valuation work is actually performed quite a long time after the effective valuation date, consideration should be given to stating in this list that the price should be "sufficiently current" and that the transaction also should have occurred prior to the effective date of the valuation. If you intend to allow the use of pricing data from transactions that occurred after the valuation effective date and were not reasonably foreseeable, that should be made clear because that would be counter to valuation principles. A market participant would not make a buy or sell decision based on information not available to him or her at the time of the transaction.
- 3. In keeping with the "cash equivalent" part of the USPAP Market Value conceptual definition, we suggest adding "or non-market financing" at the end of the parenthetical statement in part "e" of paragraph 23.
- 4. For paragraph 24, examples would be helpful. What is an example of an instance in which market inputs would not be available? In this case, is "market input" specifically limited to actual market transactions of similar assets? Otherwise, "market inputs" is a very general term and market inputs are used in the cost approach (what would it cost in today's market to recreate the utility of this asset) and the income approach (in today's market, what would a reasonable discount rate be for this cash flow). It seems as though some form of "market input" would usually be available.

Also, in the absence of market input, what would an entity use internally? An example would be helpful.

5. Also, see discussion above under Issue 5.

#### **General Comments**

The Exposure Draft does not appear to deal with the interpretation of Fair Value regarding issues of partial ownership interests, control versus minority interests, or groups (blocks) of assets. This may fall under the topic of Unit of Account in paragraph 6 or it may be a topic for future consideration.

Interpretation of the Fair Value of leased assets does not appear to be directly addressed. Perhaps this is a topic for future consideration.

The proposed Statement seems to focus on the valuation of "assets." In valuation, it is important to differentiate the asset from the interest in the asset. It is the interest in the asset that is actually being appraised. For example, in real property, the "asset" may be an office building. However, the "interest" in that asset could be complete ownership (fee simple), partial ownership, or that of a lessor or a lessee, for example. Each of these interests may have a very different value, although the underlying asset is the same.

#### Valuation Standards

The summary on page v of the Exposure Draft, and a similar statement contained in the Introduction on page 1, states "The Board expects that the guidance provided by this proposed Statement will be applied together with applicable valuation standards and generally accepted valuation practices, where appropriate." Since that is the case, it may be beneficial to consult on some limited basis with the U.S. valuation standards-setting body authorized by Congress; the Appraisal Standards Board. Such coordination could further enhance the ability of valuation professionals to interpret and abide by the requirements of this Proposed Statement of Financial Accounting Standards in the manner you wish them to. Please be assured, we are not suggesting that we would impose our opinions on the standards you are writing. We do not claim to have expertise in accounting standards. However, we may serve as a reasonable voice for valuation professionals and the standards with which they must comply.

Further, under most state laws, any opinion of real property value is required to be performed by a professional appraiser who has been licensed or certified by the state, no matter what the use of that value opinion, and is required to developed and reported in compliance with USPAP. Since many valuation professionals will need to adhere to USPAP as well as the proposed Statement, we believe that cooperation between the ASB and the FASB is in the best interest of those who rely on financial statements.

Again, we appreciate the opportunity to comment on the Exposure Draft. We plan to have a representative at the roundtable meeting later this month and look forward to the discussion there. We would welcome any questions or comments. To reach us, please contact John Brenan, Director of Research and Technical Issues, The Appraisal Foundation, direct line telephone 202/624-3044, or email john@appraisalfoundation.org.

Respectfully,

Carla G. Glass

Vice Chair

Appraisal Standards Board

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