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Ms. Suzanne Q. Bielstein, Director
Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7

Letter of Comment No:

Exposure Draft: Proposed FASB Statement, Fair Value Measurements (File Reference No. 1201-100)

Dear Ms. Bielstein:

Norwalk, CT 06856-5116

We support the Board's efforts to provide additional guidance on applying fair value measures to help preparers and auditors to comply with other authoritative pronouncements that require the use of fair value as the measurement attribute. We believe that the Exposure Draft, while written at a high level, can provide some assistance to those developing fair value estimates that will be recognized or disclosed in financial statements. While guidance on the development of fair value information is important and we support the Board's efforts to develop this guidance, the Board must ensure that its guidance is operational and the resulting information is auditable.

Our main concern about the increased use of fair value measurements in financial statements is their reliability. Level 3 estimates are often based on subjective decisions of management or valuation specialists. For many assumptions, there are ranges of possible, defensible choices, each of which would yield a different fair value estimate, and such differences could, either individually or in aggregate, be material. Even market inputs may support several different assumptions. Additionally, valuation specialists often differ in their methods and how they apply those methods.

Others have also expressed concern about the reliability of fair value measurements, including Douglas Carmichael, Chief Auditor of the PCAOB. In a recent speech, Mr. Carmichael stated that "when fair value cannot be measured by reference to matters that are directly observable, and if the measure represents little more than the measurer's state of mind, neither the measurement nor the measurement method are verifiable. In those circumstances, the independent auditor has a scope limitation and should not express an



unqualified opinion on the financial statements that are materially affected by such a measurement." In particular, guidance will be needed to implement concepts such as objectively determinable as it relates to Level 2 estimates (e.g., paragraph 20) and how to evaluate undue cost and effort for measurement techniques related to Level 3 estimates (e.g., paragraph 22). Accordingly, we encourage the Board to work actively with the PCAOB, the Valuation Resource Group, and others to ensure that the accounting guidance is operational, diversity in valuation practice is minimized, and the resulting information is auditable.

The Board also needs to engage in educational outreach to help the investing public understand the tradeoff between relevance and reliability when fair value information is included in the financial statements. In particular, the Board should help financial statement users understand that the loss of reliability that comes from using fair value information increases the likelihood that fair value information may be revised in future periods even when the current period information is appropriately determined.

In addition to these overarching points, we have the following specific comments.

Scope Exceptions

Paragraph 2(c) excludes pronouncements when revenue recognition is based on vendor-specific objective evidence (VSOE) of fair value from the scope of the Exposure Draft. Other revenue recognition standards use VSOE of fair value (e.g., EITF Issue No. 00-3, "Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware"), and still other revenue recognition standards impose other specific measures of fair value (e.g., EITF Issue No. 99-17, "Accounting for Advertising Barter Transactions"). Since the Board is actively pursuing its revenue recognition project, the Board should either exclude all revenue recognition standards or provide a comprehensive list of all revenue recognition standards that rely on a measure of fair value to be excluded from the scope of this Exposure Draft (in either case, Appendix E would need to be modified).

Fair Value Hierarchy

We agree with the Board that fair value measurements should maximize the use of market inputs to enhance the reliability of fair value estimates. The fair value hierarchy is a very useful construct for ordering and ranking fair value measurements based on the quality of market inputs in a manner that emphasizes their reliability. For that reason, we believe the draft Statement would be improved if it were re-organized to present the fair value hierarchy immediately after paragraph 6. Doing so not only will highlight the fair value hierarchy, but it will provide a framework for understanding the application of the valuation techniques subsequently discussed.



We believe that there are many circumstances where a Level 1 measure would be available. Likewise, there will be many circumstances when Level 3 measures would be needed. We believe, however, that Level 2 estimates of fair value would be available in few, if any, situations. The Board should clarify circumstances that will result in the application of Level 2 measures of fair value and include examples in the standard.

Valuation Techniques

Consistent with the concept of a hierarchy where higher levels are superior to lower ones, application of multiple valuation techniques should not be required when Level 1 estimates are available. However, paragraph 7 of the Exposure Draft states, "valuation techniques consistent with the market approach, income approach, and cost approach shall be considered for *all* estimates of fair value." (Emphasis added.) We do not believe that the use of multiple valuation techniques would result in a more reliable fair value estimate than that obtained from an observable market price. The Board should clarify that the use of multiple valuation techniques is appropriate only when Level 2 or Level 3 estimates of fair value are necessary.

Notwithstanding the requirement of paragraph 7, the Exposure Draft appears to permit the omission of other valuation approaches only when information is not available to apply them. We understand that a valuation specialist is generally required to consider, but not necessarily apply, all valuation approaches. Valuation specialists will often not apply all approaches if they believe the results of a particular approach would not be relevant. For example, Uniform Standards of Professional Appraisal Practice's (USPAP's) Standards Rule 9-4 states:

This Standards Rule requires the appraiser to use all relevant approaches for which sufficient reliable data are available. However, it does not mean that the appraiser must use all approaches in order to comply with the Rule if certain approaches are not applicable.

We believe that valuation specialists and preparers should be able to exercise their professional judgment in determining whether to apply a particular method. The valuation specialist and preparer may determine that it is not appropriate to calculate a value under one of the three approaches in certain situations. For example, for many derivative instruments for which Level 3 estimates of fair value are needed, we question the usefulness of a cost approach in determining the instrument's fair value. We believe that the Board should clarify that paragraph 7 does not impose a requirement to estimate fair value using all three valuation approaches in every circumstance (or even in every Level 3 circumstance). Rather, the valuation specialist and preparer should consider the appropriateness and usefulness of each valuation approach in estimating fair value.



We expect that many derivative instruments will be valued using Level 3 estimates. We note that in EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," the Task Force concluded that "day one" gains should not be recognized in situations where an exchange transaction indicated that the fair value of the exchange was \$0 (i.e., the transaction was entered into with no consideration exchanged). Questions have arisen on the recognition of "day two" gains on contracts when the entity's internal model indicates that a "day one" gain existed but, in accordance with EITF 02-3, was not recognized. More broadly, we believe that the Board should include a reconsideration of EITF 02-3 as a part of this project and, in doing so, should provide clear guidance on both the "day one" and "day two" gain recognition and valuation of these and similar instruments.

Reliance on Valuation Standards

The Exposure Draft states that its proposed requirements should be applied together with applicable valuation standards and generally accepted valuation practices. However, the valuation profession at this time has neither a single authoritative valuation body nor a universally-recognized process for developing and issuing such standards. Existing valuation standards were not developed through a formal "due process" system as is the case for accounting and auditing standards. If the proposed Statement is to be applied in conjunction with applicable valuation standards, guidance should be provided as to what valuation standards the Board believes are widely accepted and how to resolve conflicts between accounting and valuation standards or between valuation standards of different organizations (e.g., the American Institute of Certified Public Accountants, the American Society of Appraisers, the National Association of Certified Valuation Analysts, the Institute of Business Appraisers). The diversity of the groups that provide valuation guidance coupled with the lack of a "codified" set of standards creates the potential for confusion and inconsistent application of valuation practices. It would therefore be useful for the Board to seek the support of these valuation-related bodies as well as the PCAOB and others in developing a final Statement.

Expected Cash Flows and Concepts Statement 7

The Exposure Draft incorporates, but does not amend, guidance from FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements. However, a careful reading of the Exposure Draft would appear to contradict some of the conclusions in Concepts Statement 7. Accordingly, we believe that the Board's final Statement should make clear that it amends Concepts Statement 7 with respect to the following matters:



- The Exposure Draft clarifies that a risk-free discount rate should be applied only against certainty-equivalent cash flows. Concepts Statement 7 appears to suggest that risk-free rates could be applied against expected cash flows. We agree with the Exposure Draft's clarification of Concepts Statement 7.
- Concepts Statement 7 states that the expected present value approach is preferable to the discount rate adjustment approach, in part because of the subjectivity of estimating the risk-adjusted discount rate to be applied against cash flows. The Exposure Draft states that risk adjustments must still be applied to expected cash flows either by determining certainty-equivalent cash flows or adjusting for systematic or nondiversifiable risk in the discount rate. This means that a significant amount of subjectivity is involved in applying the expected present value technique. Moreover, Concepts Statement 7 assumes that probabilities can be assigned to the possible alternative cash flow outcomes, the difficulty of which has limited the use of this method in practice and brings an additional element of subjectivity into the expected present value technique. We believe that the guidance on the consideration of alternative outcomes in evaluating the expected present value technique is useful for preparers. However, the preference expressed in Concepts Statement 7 for the expected present value technique has created questions about the appropriateness of the discount rate adjustment approach, which is used much more frequently to price transactions. Given that both methods involve significant use of subjective judgments, we do not believe it is appropriate for Concepts Statement 7 to continue to state such a preference.
- Concepts Statement 7 states that the terms "value-in-use" and "entity specific measurement" are synonymous, suggesting that value-in-use is not consistent with fair value. The Exposure Draft states that in-use value is a valuation premise consistent with fair value. This different treatment of the relationship between value-in-use and in-use value is confusing and could be clarified by deleting the reference to value-in-use in Concepts Statement 7.

Present Value Techniques

The Exposure Draft, together with Concepts Statement 7, provides useful guidance on applying present value techniques. However, there is no mention in either document of the multi-period excess earnings technique described in the AICPA Practice Aid, "Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries," which has become widely used to value intangible assets. The Board should consider whether this method should be discussed in the proposed Statement as well as the wider



issue of consistency between the Practice Aid on Assets to be Used in R&D and the proposed Statement.

Paragraph A2 of the Exposure Draft identifies liquidity as one of the factors to be considered in estimating fair value using a present value technique. Valuation specialists often reflect the liquidity of an asset or equity interest in a valuation through the application of a discount or "haircut" for illiquidity or lack of marketability. However, the determination of such discounts is a subjective process resulting in frequent challenges to such valuations by regulatory agencies. Further guidance in this area where valuation practice and accounting requirements appear to vary would be helpful.

Paragraphs A21 and A22 differentiate between the valuation of liabilities that are held as assets by others and liabilities that represent rights that generally cannot be sold by their holders like other assets. The Exposure Draft states that the expected cash flows of these two types of liabilities are affected in opposite directions by the change in the credit standing of the obligor. This issue is not well explained and should be clarified.

Change in Valuation Techniques

Paragraph 8 of the Exposure Draft appears to require consistent application of a valuation technique from one period to the next when making fair value estimates (e.g., of an identifiable intangible asset with an indefinite life). The objective is to determine the best estimate of fair value at the time the valuation is performed. Since the fair value accounting policy is being applied from one period to the next, the entity would be consistently applying that accounting policy even when the particular valuation technique differed from one period to the next. The preparer and/or valuation specialist should have the ability to determine which valuation technique is most appropriate in a particular reporting period. This conclusion is consistent with the guidance in the AICPA Practice Aid, "Valuation of Privately-Held Company Equity Securities Issued As Compensation," which suggests that different valuation techniques would be applied at different stages in an entity's life cycle. Finally, it is not clear whether the guidance in the Exposure Draft would require consistent application of the valuation technique to the same item, the same class of asset or liability, or some other grouping of assets or liabilities.

Unit of Account

While we understand that the Board has deferred consideration of unit of account to later phases of the project, additional guidance on the following issues would be helpful at this time:



- With respect to valuing a single derivative contract, guidance should be given on whether it is permissible to disaggregate the contract into its component elements or whether the lowest unit of account would be the contract level.
- When a company has shares that are publicly traded, is it always appropriate to value the company using the quoted price of the shares (p x q)? In the Board's Purchase
- Method Procedures project, an acquirer that obtains control of an entity will step up the value of the acquired entity's assets, liabilities, and noncontrolling interest to recognize 100% of their fair value. It is not clear that the fair value of the acquired entity should always be measured using the price paid for the shares to obtain the controlling interest so that p x q would be used in measuring the noncontrolling interest. Consider, for example, two acquisitions. In the first, an acquirer obtains a 51% interest in another company in a single transaction. In the second, an acquirer previously acquired a 49% ownership interest (which could have occurred through one or several transactions). It subsequently acquires an additional 2% interest, giving it a controlling interest in the company. Should each company use the price it paid for the "controlling" shares as the basis for determining the fair value of the acquired company?

Valuation Premise

We believe that in valuation practice "valuation premise" refers to the use to which an asset will be put rather than the condition or location of the asset. We believe that the first sentence of paragraph 13 should be modified so that valuation premise does not appear to be a function of the condition of the asset. While we agree that an in-use valuation premise is appropriate and is consistent with current valuation practice, it may be inconsistent with the discussion of fair value in the Practice Aid on Assets to be Used in R&D, when fair value is assumed to be based on a transaction when the asset is bought or sold on a piecemeal basis. The Practice Aid also states that in-use value is not consistent with fair value. Given the widespread use of the Practice Aid, particularly in valuing intangible assets, the Board should address this apparent inconsistency.

Valuing Securities Using Bid-Asked Prices

Paragraph 17 of the Exposure Draft states, "where bid and asked prices are more readily and regularly available than closing prices, fair value shall be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities). For offsetting positions, mid-market prices shall be used for the matched portion." We understand the term "offsetting" is used in this context to mean "risk offsetting," the usage in IAS 39, Financial Instruments: Recognition and Measurement, rather than the right to set-off, the usage in FASB Interpretation No. 39, Offsetting of Amounts Related to Certain



Contracts. To avoid confusion, the Board should clarify that footnote 8 refers to balance sheet presentation only.

Active Markets

Paragraph B18 of the Exposure Draft incorporates guidance from SEC ASR No. 113, Statement Regarding "Restricted Securities." Item (d) in paragraph B18 indicates that the market value of a stock may not be equal to fair value if the market is very thin. This appears to conflict with the fair value hierarchy unless a thin market is the equivalent to a market that is not active. The Board should clarify how this guidance relates to the requirement in the Exposure Draft that when Level 1 measures are available, fair value is determined as p x q. This would seem to apply to all securities traded in an active market, even those that are thinly traded.

Consideration of SEC Rules

We believe that certain aspects of the Exposure Draft may be inconsistent with current SEC rules. For example, application of the "most advantageous market" concept, as discussed in paragraph 16 of the Exposure Draft in the context of Level 1 estimates, is not necessarily consistent with the requirements of ASR No. 118, Accounting for Investment Securities by Registered Investment Companies, which calls for use of the market in which the security is "principally traded." Further, paragraph 18 of the Exposure Draft requires companies to establish and consistently apply a policy related to significant events occurring after the close of a market but before the end of the reporting period. In contrast, the SEC rules require certain investment companies to adjust for the effect of significant events occurring after the close of the market from which it typically obtains price data. The Board should work to ensure that its standard and relevant SEC rules are consistent.

Restricted Securities

The Exposure Draft incorporates guidance on valuing restricted securities from ASR 113. Additionally, the Exposure Draft would modify the use of the term "restricted securities" as used in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. We believe that the definition of "restricted securities" in the Exposure Draft is appropriate. We also agree that it is appropriate to value a restricted security by taking an adjustment to the market value of an identical unrestricted security. However, the Board should provide additional guidance on how the amount of the discount should be determined. For example, would the premium that the holder would have to pay to buy a put on the security be an appropriate discount or would multiple valuation techniques be required (with the put premium being one of the techniques) to estimate the amount of the discount?



Distinction between Fair Value and Investment Value

Paragraph B2 of the Exposure Draft explains that investment value reflects value that is unique to a specific buyer or seller and, therefore, does not reflect fair value. Paragraph B3, however, appears to suggest that where a buyer with unique synergies buys a business, the price paid reflects fair value, even if it may include buyer-specific synergies, apparently because it represents an actual price paid in a current transaction between unrelated parties. Current valuation practice when using this approach would exclude from the estimate of the fair value of individual intangible assets any buyer-

specific synergies that could be included in the overall fair value of the business. Moreover, in establishing fair value thereafter, e.g., for testing goodwill impairment, valuation specialists would not include buyer-specific synergies in estimating the fair value of the reporting unit. The Board should clarify whether these current practices are consistent with the meaning of paragraph B3.

Disclosures

The Exposure Draft would require certain disclosures to be made for each interim and annual period for which a statement of financial position is presented. The Board should clarify whether those disclosures would be required for all periods presented in comparative financial statements.

If you have questions about our comments or wish to discuss any of the matters they address, please contact John Guinan at (212) 909-5449 or Paul Munter at (212) 909-5567.

Sincerely,

KPMG LEP



Appendix - Response to Issues Identified in the Exposure Draft

	Issue	KPMG's Views
1.	Will entities be able to consistently	We believe that the Exposure Draft will
	apply the fair value measurement	facilitate the measurement of fair value.
	objective using the guidance provided	However, the Board should use an
	by this Exposure Draft together with	implementation group to provide guidance
į	other applicable valuation standards	on how to apply the requirements and to
	and generally accepted valuation	narrow diversity in valuation practice. The
	practices?	Board should also work with appropriate
		standard setters and others to ensure that
		guidance on auditing fair value information
 		is established. Further, on future projects
increase and the second		where the Board determines that fair value
		is the appropriate measurement attribute,
		the Board should consider the use of field-
		testing to determine whether the standards
		being developed would be operational.
2.	Is there sufficient guidance on	Our comments in the letter address our
i	present value techniques in the	concerns regarding operationality. Further,
	Exposure Draft and Concepts	we believe that the proposed Statement
	Statement 7?	effectively amends Concepts Statement 7,
		particularly as it relates to guidance on
		applying the risk-adjusted rate when
		discounting expected cash flows. Further,
		the Board should discuss the application of
<u> </u>		the multi-period excess earnings technique.
3.	Is there sufficient guidance on what	The Board should clarify whether a thin
	constitutes active market?	market as used in ASR 113, which is
	•	incorporated in the Exposure Draft, is not an active market for purposes of applying
		the Exposure Draft's provisions.
A	Is the guidance on voluction	We believe that the guidance on valuation
4.	Is the guidance on valuation	premise is helpful. However, the Board
	premise sufficient?	should clarify the application of the
		information on valuation premise in the
		Practice Aid on Assets to Be Used in R&D,
1		in particular, whether that guidance is
		consistent with the Exposure Draft.
5.	Is the guidance on the fair value	We believe that the fair value hierarchy
"	hierarchy sufficient?	captures the concept of maximizing market
	The state of the s	inputs on which fair value measurements
		are based. Because the guidance on the fair
		value hierarchy is important, the Exposure
1		Draft should be reorganized to provide that



		discussion earlier in the final Statement.
6.	Is the guidance on Level 1 reference markets sufficient?	Yes, the guidance is adequate.
7.	For financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices, should fair value be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions?	We agree with the Board's conclusions. However, the Board should clarify the meaning of offsetting positions.
8.	Do we agree that block discounts should not be allowed, except for companies that apply the AICPA Audit Guides for investment companies and broker-dealers?	We believe this issue requires further study and encourage the Board to carefully consider it in a subsequent phase of the project.
9.	Do we believe that the guidance on applying Level 3 valuation techniques is sufficient?	We believe that there is a need for the Board to work with the PCAOB, Valuation Resource Group, and others to ensure that sufficient implementation guidance and appropriate auditing standards are put in place so that the resulting information is sufficiently reliable and auditable.
10.	Is the guidance to apply to restricted securities sufficient?	We believe it is appropriate to incorporate the guidance from ASR 113. However, additional guidance should be provided on quantifying the restriction (e.g., the premium on a put).
11.	Would the required disclosures improve the quality of information available to the users of financial statements?	We believe the disclosures will provide useful information.
12.	Does the proposed effective date provide sufficient time for entities to make the changes necessary to implement the Exposure Draft?	The Exposure Draft does not create new requirements to measure fair value, and, therefore, the effective date does not impose an undue burden.
13.	What other issues should the Board address in subsequent phases of the project?	The Board should establish a clearer framework for evaluating the tradeoff between relevance and reliability so that the Board's constituents can better



	understand the Board's decision to require	
	fair value information in specific projects.	
	The Board should also coordinate the	
	issuance of the final Statement with the	
	issuance of any resulting modifications of	
	SEC regulations that would be needed. For	
	example, application of the "most	
	advantageous market" concept, as	
	discussed in paragraph 16 of the Exposure	
	Draft in the context of Level 1 estimates, is	
	not necessarily consistent with the	
	requirements of ASR 118 which calls for	
·	the use of the market in which the security	
	is "principally traded."	
14. Are we interested in attending the	Yes.	
roundtable meetings?		