



Letter of Comment No: 12
File Reference: 1201-100
Date Received: 9-1-04

September 1, 2004

Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CN 06856-5116

File Reference No. 1201-100

Dear Sir or Madam:

The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide our perspective on the Exposure Draft of a Proposed Statement, Fair Value Measurements. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which the members are associated.

The Committee agrees with the major conclusions of the Exposure Draft. Our specific comments relative to the issues are as follows:

Issue 1: The Committee agrees with the Board's definition of fair value and the fair value measurement objective set forth in the Exposure Draft. The Committee believes that companies will be able to consistently apply the fair value definition and objective using the guidance provided in the Exposure Draft.

Issue 2: The Board requested feedback on Appendix A of the Exposure Draft which provides guidance for using present value techniques to estimate fair value. The Committee has three comments related to the guidance set forth in Appendix A. First, the Committee believes it is unclear in paragraph A2(e) whether the Board intended to direct companies to a) attempt to replicate market imperfections that would exist in a market or b) correct for market imperfections that might exist when making fair value estimates using a present value technique. The Committee believes the Board should provide clarification on this point and recommends that companies should only attempt to correct for market imperfections that might exist; companies should not be expected to attempt to replicate pricing errors.

Second, the Committee believes that the present value technique examples in paragraphs A7 and A16 are misleading because they do not explicitly consider the extent to which the risk inherent in the asset is systematic (non-diversifiable). In paragraph A7, the example illustrating the concept of risk is silent on the issue of systematic risk, stating only that investors would pay "something less for Asset B, depending on the price (risk premium) that marketplace participants would demand for bearing the uncertainty inherent in the cash flows." However, that risk premium would depend critically on the correlation between the cash flow outcome and the cash flow outcomes on all other assets in the market (the asset's "beta" in a capital asset pricing model framework). In paragraphs A16-A18, the present value technique example goes through a computation of expected present value (fair value) without the information that would be necessary to determine the appropriate discount rate. The example states there is a risk premium of 3 percent, but does not state the extent to which the expected cash flow distribution is correlated with the market (beta), which would determine the appropriate risk premium and hence discount rate to use in the computation of expected present value (fair value). The example implies that the mere fact that the expected cash flows are uncertain results in a risk premium, which may not be accurate. The Committee believes that only uncertainty that cannot be diversified (i.e. correlation as measured by beta) should result in a higher demanded rate of return. For example, if the asset in this example had a beta of zero (i.e. the expected cash flow outcome was uncorrelated with the expected cash flow outcomes of other assets), the appropriate discount rate for calculating expected present value (fair value) would be the risk-free rate, notwithstanding the fact that the cash flow is risky.

Third, the Committee believes that the illustration of a fair value measure based on a single best estimate cash flow in paragraph A14 is flawed because it ignores the rest of the distribution of possible cash flow outcomes. A more relevant fair value measure is the expected cash flow value, which measures the central tendency of the distribution.

Issue 3: The Committee believes that guidance is sufficient for identifying active markets with readily and regularly available quoted prices.

Issue 4: In the Exposure Draft the Board provided general guidance and examples (in Appendix B) for selecting the valuation premise that should be used for estimates of fair value. The Committee believes that it is unclear whether paragraph 21 requires the use of multiple valuation techniques when quoted prices for identical or similar assets or liabilities in active markets are not available and the information necessary to apply those techniques is available without undue cost and effort. The examples of fair value assessments in paragraphs B11-B16 imply that the use of multiple valuation techniques is required. The Committee believes that multiple valuation techniques should be used during the initial estimate of fair value of an asset or liability after the adoption of this Exposure Draft (e.g. the first SFAS 142 goodwill impairment test, the first SFAS 144 long-lived asset impairment test, etc.). The valuation method that best approximates what an exchange price would be in the circumstances should then be used for recording the asset or liability at fair value in the financial statements. Differences between the results of multiple valuation techniques and the rationale for

choosing the final valuation technique should be documented. However, after the initial fair value assessment of an asset or liability, the chosen valuation method should be applied consistently going forward for that asset or liability. To illustrate, the example in paragraph B11 demonstrates the application of multiple valuation techniques for machinery that is used in income-producing activities of an entity. This exercise could likely be part of a SFAS 144 long-lived asset impairment test. In this example, the valuer applies multiple valuation techniques through a market approach and a cost approach using quoted prices adjusted as appropriate. The valuer then determines that the inputs used in the market approach are more relevant and reliable than those used in the cost approach primarily because they require fewer and less subjective adjustments. In this case, the valuer should document the fair value assessment of the machinery and the rationale for choosing the market approach as the best estimate of fair value. The valuer should then be able to apply the market approach in future fair value assessments of that machinery since that approach was determined to be the most relevant and reliable measure of fair value for the asset during the initial assessment. After the initial fair value assessment of an asset or liability, there should be no requirement to continue using multiple valuation techniques on a go-forward basis unless significant circumstances or assumptions change as the Committee believes that in many cases one single methodology may be "validated" as providing superior results during the initial fair value assessment of an asset or liability.

Further, in the example in paragraph B11, the valuer decides not to use an income approach when applying multiple valuation techniques because the machinery does not have a separately identifiable income stream. The Committee agrees that most operating assets are integrated, so it is generally impossible to isolate the cash flow stream to be expected for the asset on an in-use basis. The Committee believes this guidance should be incorporated into the primary text of the Exposure Draft, rather than just appearing in Appendix B.

In addition, the example provided in paragraph B14 illustrates an income approach resulting in a fair value of \$15 million, while a cost approach yields a fair value of \$1 million. The Board concludes that the \$15 million is more relevant and reliable. However, the fact that a similar asset could be acquired for \$1 million suggests that competitors are likely to do just that, and the income projection underlying the \$15 million value under the income approach may well be overstated, thus casting doubt on its reliability. Overall, the Committee believes this example does not appear to be realistic, since a fair value disparity of this magnitude generally would not be observed in practice.

Issue 5: The Committee believes that the guidance is sufficient for making assessments of fair value hierarchy inputs.

Issue 6: The Committee believes that the guidance is sufficient for selecting the appropriate reference market. However, the Committee believes that favorable quoted prices with very little depth may not represent quoted prices at which an asset or liability could actually be exchanged. Therefore, the Committee suggests clarifying in paragraph

16 that companies should consider not only the quoted prices but also the market depth when determining the Level 1 reference market.

Issue 7: The Committee disagrees with the Board's conclusion in paragraph 17 that fair value be estimated using bid prices for long positions and asked prices for short positions for instruments traded in active dealer markets. If one views the bid-ask spread as a transaction cost (a "round-trip" requires payment of the bid-ask spread, in addition to any other costs, such as commissions), then the guidance in paragraph 17 is inconsistent with paragraph 16, which precludes the incorporation of transaction costs in the measurement of fair value. Therefore, the Committee believes that average price should be used to estimate fair value of instruments traded in active dealer markets.

Issue 8: Conceptually, the Committee agrees that the use of a block factor is appropriate. A large block of securities, for example, is likely to trade between willing, unrelated parties at a per unit price higher than the trading price for an individual security or a small block of securities. Ignoring a block premium ignores this component of the security's value. It also suggests that a loss may be recorded upon purchase of a block of securities, because any premium paid would not be included in the subsequent valuation of the securities.

The Committee believes it would be difficult and inappropriate to provide specific percentage cutoffs for when a block premium should be included in a valuation or how a block premium should be computed. Rather, an evaluation of the specific facts and circumstances is necessary to determine whether a block factor should be applied in a valuation. The Committee believes the following guidance for evaluating the specific facts and circumstances would be appropriate:

A block factor should be applied whenever holdings are substantial enough that a willing buyer would pay more per unit for the block than for an individual unit. This will depend on the following factors:

- a) The size of the block.
- b) The concentration of other holdings of the same security.
- c) The incremental value that accrues to the holder of the block.
- d) What restrictions, if any, limit the ability of the block holder to exert influence.

Items (a) and (b) address the extent to which the block holder will have the ability to influence decisions based on concentration of voting power. For example, a 40% block could be a very powerful voting block if the other 60% of the securities are widely held, while it would have insignificant power if the other 60% are held by a single entity.

Item (c) addresses the value that may be derived from the block. This might depend on the extent to which the holder can improve operations or derive value from intercompany transactions as a result of influencing operating decisions.

Item (d) takes into account factors such as statutory restrictions or restrictions in the firm's charter (e.g. staggered board terms, supermajority voting requirements) that may mitigate the block holder's ability to derive any economic benefit from the block.

Issue 9: The Committee believes that the guidance is sufficient related to applying multiple valuation techniques. However, please see our comment on Issue 4 regarding the overall concept of using multiple valuation techniques.

Issue 10: The Committee recommends that additional guidance be provided related to fair value estimates of restricted securities. Paragraph B17 explains that when estimating the fair value of restricted securities, the quoted price of an otherwise identical unrestricted security should 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. Additional guidance is provided in paragraph 18 for determining an appropriate discount rate for restricted securities. This guidance is not very useful in that it generally describes what *not to do* when determining the discount rate for restricted securities (see items a-d and f). The Committee believes additional guidance explaining what *to do* when determining the discount rate for restricted securities, including some examples, would be helpful.

Issue 11: The Committee disagrees with the Board's conclusion that additional fair value measurement disclosures would improve the quality of information provided to users of financial statements. The Exposure Draft requires expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. The Exposure Draft also encourages disclosures about other similar remeasurements that, like fair value, represent current amounts. The Committee believes that in most cases the disclosures described and illustrated in the Exposure Draft merely duplicate information found elsewhere in annual financial statement disclosures (e.g. derivatives footnote, investments footnote, critical or significant accounting policies). The Committee also believes that most financial statement users will understand the fair value disclosures found throughout the existing footnotes and it is not necessary to accumulate that information again in a new disclosure. Accumulating the data to compile the expanded disclosures will be burdensome and require judgmental distinctions of what type of data most significantly contributed to the valuations, while not providing an incremental benefit to users of the financial statements.

Issue 12: The Committee agrees with the Board's proposed effective date. However, the Committee does not believe that only adjustments resulting from applying paragraph 17 of the Exposure Draft should be treated as a cumulative effect of a change in accounting principle. Rather, the Committee suggests that *all* adjustments resulting from changes in valuation methods upon adoption of this Statement be treated as a cumulative effect of a change in accounting principle.

Issue 13: The Committee has no recommendation on future fair value issues for the Board to address.

The members of the Accounting Principles Committee of the Illinois CPA Society thank you for the opportunity to respond to this Exposure Draft. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

A handwritten signature in cursive script, appearing to read "J.L. Fuehrmeyer, Jr.", written in black ink.

James L. Fuehrmeyer, Jr., Chair
Accounting Principles Committee

**ILLINOIS CPA SOCIETY
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2004 - 2005**

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education, government and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.

Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:

Large (National & Regional Firms):

Janet I. Chase, CPA
James L. Fuehrmeyer, Jr., CPA
Brian L. Heckler, CPA
Alvin W. Herbert, Jr., CPA
Steven C. Johnson, CPA
Lisa M. Koblinski, CPA
Kirsten M. Lescher, CPA
Daniel J. McMahon, CPA
Richard H. Moseley, CPA
J. Christopher Rabin, CPA
Mark K. Scoles, CPA
John M. Stomper, CPA
Joan Waggoner, CPA

Medium (more than 40 employees):

Marvin A. Gordon, CPA
Ronald R. Knakmuhs, CPA
Laurence A. Sophian, CPA

Small (less than 40 employees)

Walter J. Jagiello, CPA
Kathleen A. Musial, CPA
Roger L. Reitz, CPA
John A. Rossi, CPA

Industry:

Peter J. Bensen, CPA
Melinda S. Henbest, CPA
Bavan Holloway, CPA
James B. Lindsey, CPA
John H. Wolter, CPA

Educators:

David L. Senteney, CPA
Leonard C. Soffer, CPA
Charles A. Werner, CPA

Staff Representative:

Altschuler, Melvoin & Glasser LLP
Deloitte & Touche LLP
KPMG LLP
Clifton Gunderson LLP
McGladrey & Pullen, LLP
Ernst & Young LLP
Plante & Moran, PLLC
Virchow, Krause & Company, LLP
Altschuler, Melvoin & Glasser LLP
Altschuler, Melvoin & Glasser LLP
Grant Thornton LLP
Deloitte & Touche LLP
Blackman Kallick Bartelstein LLP

Baygood, Telpner & Rose Chartered
Miller, Cooper & Co. Ltd.
Ostrow, Reisin, Berk & Abrams, Ltd.

Walter J. Jagiello, CPA
Benham, Ichen & Knox LLP
Cray, Kaiser Ltd., CPAs
William F. Gurrie & Co.

McDonald's Corporation
The Boeing Co.
The Boeing Co.
TTX Company
Retired/Natural Gas Pipeline Company of America

Ohio University School of Accountancy
University of Illinois at Chicago
Loyola University

C. Patricia Mellican, CPA

Illinois CPA Society