

Letter of Comment No: 70
File Reference: 1201-100
Date Received: 9-8-04

September 6, 2004

Technical Director - File Reference No. 1201-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Appraisal Issues Task Force Comments to the Exposure Draft on Fair Value Measurements - File Reference No. 1201-100

Dear Sir or Madam:

This comment letter comes from the Appraisal Issues Task Force ("AITF"), a voluntary, industry-wide consortium of business valuation professionals who wish to improve the practice of valuation. The AITF focuses on valuation for financial reporting issues arising from the transition to fair value accounting. Our periodic meetings are open to all interested parties. We especially welcome representatives from the FASB and the SEC. For more information, please visit the AITF web site at www.aitf.info.

On August 2, 2004, the AITF held its summer quarterly meeting in Norwalk, Connecticut. Three members of the FASB attended. The meeting centered on the Exposure Draft on Fair Value Measurements. The consensus of the AITF was to respond to 8 of the 14 issues.

Issue 2 – Valuation Techniques

We found the guidance in Appendix A helpful and appreciate the efforts of FASB to clarify the valuation methods described in Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, we continue to have practical concerns and technical questions regarding its application. As you are aware, the "expected present value technique" discussed in paragraphs A12-A19 is rarely used in the valuation community. To be more widely used, we believe it is necessary to demonstrate that the technique provides more reliable and defensible valuations. However, at this point in our understanding of the "expected present value technique," we do not believe adoption will achieve that result.

Our first difficulty in applying the "expected present value technique" comes from estimating the probabilities to be applied to each cash flow scenario. We are aware of few observable market inputs for estimating these probabilities; some data may exist for early-stage development companies and for pharmaceutical companies bringing drugs through the FDA approval process. Without observable and verifiable market inputs, we worry about the reliability of the result and

our ability to defend it. In addition, the requirement to use highly subjective inputs tends to "open the door" to misuse of a method. In general, the fewer subjective estimates and adjustments required to be used in a valuation method, the more reliable it is.

We also have concerns and questions surrounding selection of the discount rate to apply to cash flows under the various scenarios in the "expected present value technique." We appreciate your clarification of the risk-adjusted discount rate ("Method 2") and the addition of systematic risk. We understand the systematic risk in the context of the Capital Asset Pricing Model ("CAPM") to be the equity risk premium multiplied by the beta of the asset. An example or note connecting the practical use of CAPM, the equity risk premium, and beta to systematic risk would be helpful. In addition, we are uncertain whether your understanding of systematic risk would allow the inclusion of a small-stock premium, if applicable, in the CAPM. Such a premium is almost a given in valuation contexts involving private equity and smaller public companies.

Finally, we are uncertain as to how much disaggregating of the cash flows into multiple scenarios and the application of probabilities to those scenarios would reduce the discount rate we would otherwise apply using the "discount rate adjustment technique," or if it would reduce it at all. If the discount rate used under Method 2 of the "expected present value technique" is lower than that used under the "discount rate adjustment technique," we do not believe there are observable market data for such a discount rate and are concerned with how it could be reliably estimated. Again, the use of subjective inputs tends to reduce the reliability of a valuation technique and makes it susceptible to abuse.

As a practical matter, it is often difficult for a company to develop even a single projection of likely cash flows expected for the subject asset. Developing a set of reasonable projections that estimate potential cash flows under different scenarios is an additional burden for companies and for valuation experts. That additional burden should result in more reliable and defensible valuations to justify the additional required effort. Given our concerns discussed above, we are doubtful this would be the case.

In summary, we believe the use of the "expected present value technique" will, in most cases, lead to more entity inputs and fewer market inputs, and result in less-verifiable estimates of fair value. We also think that use of the "expected present value technique" will move application of the income approach further down the proposed fair value hierarchy.

Issue 3 – Active Markets

We agree with the guidance provided in Paragraph 9 that valuation techniques should emphasize market inputs, or those assumptions and data that marketplace participants would use to estimate fair value. We also agree that market inputs derived from active markets provide more-verifiable estimates of fair value than unsupported entity inputs.

Paragraphs 10-12, however, seem to focus on data derived from active markets to perform Level 1 estimates of fair value for financial instruments. The valuation practitioners in AITF deal primarily with the valuation of closely-held financial instruments and of intangible assets for which no active market exists. The guidance on active markets, therefore, does not address the question of how market inputs can be derived, verified, and used to determine Level 3 estimates of fair value under market, income, or cost approaches to value.

Issue 4 – Valuation Premise

The valuation premises discussed include those of value-in-use and value-in-exchange. The discussions detailing those two premises of value are appropriate and correct. However, other premises of value do exist and may be appropriate. These include forced liquidation and abandonment.

For example, the FCC may require a purchaser of a wireless telephone network to sell certain wireless licenses to gain approval of the transaction. Similarly, the FDA may direct a pharmaceutical company to sell certain acquired drug lines in order to gain FDA approval of an acquisition. In these cases, the appropriate premise of value is forced liquidation.

In other transactions, the acquiror may decide to abandon an acquired trademark and re-brand the acquired products. Likewise, a buyer may rationalize and discontinue certain R&D projects. In these cases, the abandoned assets have no value to the acquiror.

As the ED currently addresses the issue, selecting an appropriate valuation premise can be problematic to the valuer of the assets. On the one hand, the intended use of an acquired asset may be quite specific to the buyer, as illustrated by the trademark example above. In most cases, it may be impossible to determine what a “market participant’s” perspective might be without “undue cost and effort.” While we agree that market inputs are superior to entity inputs, we request more guidance on balancing the potentially costly and burdensome effort required to accumulate market inputs when entity inputs are readily available to aid in the selection of the premise of value.

Issue 5 – Fair Value Hierarchy / Issue 9 – Level 3 Estimates

The Exposure Draft (Paragraphs 14-24) defines a “fair value hierarchy” based on the inputs that should be used to estimate fair value. The hierarchy “gives the highest priority” to market inputs and the “lowest priority” to entity inputs.

A Level 1 estimate is based on quoted prices for identical assets or liabilities in an active market. A Level 2 estimate is derived from quoted prices of similar assets, provided the price effects of differences can be determined objectively. Where neither Level 1 nor Level 2 is possible, a Level 3 fair value estimate shall be based on using multiple valuation techniques consistent with the market, income, and cost approaches.

The AITF believes that if the Statement were to include a more-robust discussion of the consideration of the market, income, and cost approaches in determining fair value, the Statement not only would be more consistent with widely promulgated valuation standards, but also would allow elimination of the artificial distinctions between “Level 1,” “Level 2,” and “Level 3” estimates. The result would be a statement that is both easier to apply and more familiar to valuation professionals without compromising the excellent FASB guidance.

The AITF also believes that the proposed guidance in paragraph 21 requiring the use of multiple valuation techniques to determine Level 3 estimates should be reconsidered. Professional valuation standards and practices require consideration of the cost, market, and income approaches to the valuing an asset. Within the meaning of “consider” is the latitude not to use one of the approaches if it is inappropriate to the valuation of the asset or if the data necessary to employ the approach are not available. The valuation professional is then required, under professional valuation standards and practices, to reconcile the results produced by the different approaches in reaching his or her opinion of value. The reconciliation process includes reexamining the quality

of the data used in the approaches. The process may result in selecting a value that is the result of assigning "weights" to the values resulting from the various approaches.

Consider, for example, a Level 1 estimate. In this case, a particular indicator of value (the quoted market price) is so superior that the other approaches (income and cost) would not be considered as providing credible evidence of a different fair value. In such a case, the professional would apply only the market approach. This would be the same result as that obtained from applying the Level 1 distinction in the ED.

Valuation standards also require justification of how various approaches and methods are reconciled in reaching a conclusion of value. The guidance in a final Statement should, therefore, more clearly indicate that the market, income, or cost approaches to determining value are not always relevant and in different situations could result in different estimates of value that are of differing levels of importance. Further, the Standard should indicate that a significant part of any valuation involves identifying the methods that should be applied and also how the results obtained from different methods should be assessed in reaching a final estimate of fair value.

The AITF believes that nonfinancial assets and liabilities, as well as illiquid financial assets and liabilities, would typically be more likely to require measurement using Level 3 estimates than would liquid financial assets and liabilities. Level 3 estimates require the professional to exercise more judgment than does either Level 1 or Level 2. Accordingly, the final Statement should provide more guidance, perhaps through additional examples in Appendix B, relating to nonfinancial assets and liabilities (e.g., real estate or intangible assets acquired in a business combination, impaired assets, or warranty liabilities). One such addition might demonstrate the use of the multi-period excess earnings method (a form of discounted cash flow analysis) to estimate the fair value of intangible assets acquired to be used in research and development activities for purposes of allocating purchase price pursuant to FASB Statement No. 141, *Business Combinations*.

Finally, we suggest that it be made clear that the Examples in Appendix B are meant only to illustrate certain valuation principles, not provide rules for practitioners to follow. We are particularly concerned that rote adherence to any of the examples, where the facts of the valuation differ, will result in a misuse of the example.

Issue 8 – Measurement of Blocks

It is the recommendation of the AITF that the appropriate unit of account is the block, or total ownership interest, and not the individual trading unit. And, if the unit of account is the position held, then $p \times q$ is only the starting point for the valuation. Additional considerations may include blockage discounts, as well as premiums for control or for a "swing vote" position. We also hope that the Board will revisit the "Trading Volume Formula" in SEC Rule 144 for guidance regarding how to determine whether a block does, in fact, exist.

Issue 11 – Fair Value Disclosures

In the process of our valuation analyses, we use financial statements. Therefore, we strongly encourage the expanded disclosures. We think the required and recommended disclosures are appropriate and helpful to users of financial statements. We also think it is particularly important that such users be aware (a) that certain fair value measurements for intangible assets require much judgment, and (b) that the range of fair value indications for a given intangible asset can be broad relative to other types of assets, even given the best intentions and most advanced valuation

techniques. We believe the disclosure requirements achieve this goal and applaud FASB's efforts in this regard.

Issue 13 – Other Issues

We believe that it is essential for the Board to address the issue of fair value as it applies to private equity. Fair value in that context will, we believe, require the use of Level 3 estimates more often than will its public-equity counterpart. Accordingly, we would like to reiterate our previous request to see more Level 3 estimates shown in the examples in Appendix B. The presentation in the Exposure Draft implies that Level I estimates can be used far more often than we believe they can. Because there are many more private companies than public ones, we believe that the presentation of examples will better reflect the reality of fair value issues if more Level 3 estimates were both presented and used.

The AITF appreciates your requests for comment and your participation in our meetings. Please feel free to call me at (415) 764-1677 or contact me by e-mail at gmehm@american-appraisal.com if you have any further questions.

Very truly yours,

APPRAISAL ISSUES TASK FORCE

Gerald J. Mehm
Chairman