Letter of Comment No: 47 File Reference: 1201-100

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Director Financial Accounting Standards Board

Dear Director:

File Reference No. 1201-100 ED on Fair Value Measurement

My comments on the ED are organized by the topics listed here and are discussed in detail below:

- 1. Measurement of fair value based on assumptions that marketplace participants would use.
- 2. The meaning of a fair value measurement that is not affected by factors specific to a particular entity.
- 3. Distinctions between fair value and investment value.
- 4. The inclusion of marketplace versus buyer-specific synergies in fair value
- 5. Going concern versus in-exchange valuation.
- 6. The meaning of "similar assets" and how to distinguish between Level 2 and Level 3 estimation.

Most of my comment letter includes suggestions to the FASB for adding more explanations for definitions of certain terms and concepts, and also focuses on some implementation issues.

Concept of Fair Value:

The concept of fair value as used in the ED is quite specific:

"Conceptually, fair value is a market-based measurement that is not affected by factors specific to a particular entity. Accordingly, it represents an unbiased measurement that is consistent from period to period and across entities." (para C2).

One of the issues that may require some clarification is what the ED means by "factors specific to a particular entity." For instance, it raises the issue of the relevance of fair value estimates when factors specific to the entity reporting the fair value are ignored. For instance, if a real estate land developer has properties that are different from the properties that were sold recently, should this difference be ignored in the fair value of estimation of its properties? It appears that the ED has thought about this issue and provided Level 3 estimate as an option, where significant entity inputs may be used.

However, should such entity inputs consider factors specific to the reporting entity? Para 24 indicates clearly that the objective of fair value estimation (estimating the price in a hypothetical transaction between knowledgeable, unrelated willing parties) is the same even when using a Level 3 estimation. However, it is not clear if the term "knowledgeable" refers to all that is publicly available, or does it include information that could potentially be obtained from the reporting entity? For example, does the fair value of a software product include revenue projections that represent market expectations (e.g., forecasts by industry experts) or can it include entity-specific estimates about expected future revenues? The SFAC No. 7 address this issue as follows:

"A particular entity may, in fact, possess advantages or disadvantages relative to others. The use of fair value in measurements at initial recognition or fresh-start measurements results in accounting recognition of the economic impact of those advantages or disadvantages as they are realized, rather than at initial recognition." (para 36).

In other words, the fair value estimate of an asset (or liabilities) must consider all entity-specific information to the extent such information is consistent (or at least not inconsistent) with the market expectations. This is further discussed in SFAC No. 7:

"The use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information." (para 38, SFAC No. 7, emphasis added).

The highlighted phrase may be subject to different interpretations. How would this fair value concept be operationalized, say, when testing for impairment of assets? Should the reporting entity consider a hypothetical scenario in which the marketplace participants have the same private information about asset impairment as the reporting entity and examine if they would have used the same assumptions as those chosen by the reporting entity? An alternative interpretation is that the reporting entity must not include entity-specific negative information (disadvantages) about impairment that is not consistent with market expectations. Under this interpretation, an impairment charge may not provide new information to investors given that the reporting entity must wait for the market expectations to reflect its private information. The final standard could include guidance clarifying this issue.

Valuation Techniques and Valuation Premise:

Under the market approach to valuation, fair value estimates must be based on the value indicated by actual transactions. However, the ED indicates that "buyer-specific synergies are inconsistent with fair value and would only be included in investment value." (para B2). One would expect that actual transaction values do reflect buyer-specific synergies, and if so, the issue is how should one determine whether an

¹ One issue is whether this measurement concept also applies to fair value estimates made subsequent to the initial recognition. It is assumed that this is the case.

observed transaction price represents investment value or fair value. Although Example 1 of the ED addresses this issue in some detail, there are some unresolved issues. Consider the following quote from the ED:

"That premium would not necessarily reflect the value of the synergies. Nor would it necessarily reflect an overpayment. Rather, that premium would reflect the amount that the particular buyer is willing to pay over the other bids to acquire those synergies. The price, determined in an exchange between unrelated willing parties (buyers and sellers), would represent fair value." (para B3).

If the buyer was willing to pay more than the other competitive bidders to acquire the synergies, why doesn't the premium represent buyer-specific synergies? Does the last sentence quoted suggest that all observed transaction prices are fair values? Are there circumstances in which this may not be true? For instance, a well-known valuation consultant suggests that transaction prices are more likely to represent investment values when the CEO hubris is high. Should a reporting entity consider factors such as CEO hubris in distinguishing between fair value and investment value?

The ED distinguishes between marketplace synergies and buyer-specific synergies. Are marketplace synergies included in fair value? Given that fair value "reflects value in the market and is determined based on the assumptions of marketplace participants," one would expect marketplace synergies to be included in fair value. Recall Example 1 of ED, which indicates that an acquisition premium may reflect the amount that a buyer is willing to pay for buyer-specific synergies, and such a premium will be reflected in the fair value at inception. But, how should such an asset be fair valued at the end of the next reporting period? Given that the premium reflected in the originally observed price is "the amount that the particular buyer is willing to pay" for the synergies, should the revised fair value reflect such buyer-specific synergies as well? Or should the revised fair value reflect only marketplace-specific synergies? In other words, how should a reporting entity distinguish between investment value and fair value at inception (when an asset is purchased) and in the future (when the asset is fair valued periodically, if required by an accounting pronouncement)?

Under the cost approach, the "estimate of fair value considers the cost to acquire a substitute asset of comparable utility, adjusted for obsolescence." Depending on how the term "cost" is interpreted, there might be implementation differences. Consider Example 7 in the ED (paras B13-B14). The example considers a scenario, which requires the estimation of the fair value of income-producing software. The fair value of the software is estimated at \$15 million (\$1 million) using the income (cost) approach. It appears that the ED uses "out of pocket" costs as a proxy for the replacement cost of an ex post successful software. It is not clear whether this is the relevant cost measure in the given context. For instance, the fair value of a single successful oil field under the "cost approach" would equal the cost of the success oil field plus the cost of drilling the dry holes. In other words, while a reliable estimate of the "out of pocket" costs of a single successful oil field can be made, it may not be relevant (consistent with the discussions in the ED on the software example). In such

² See Pratt, S.P. 2001. The Market Approach to Valuing Businesses. New York, NY: John Wiley & Sons, Inc.

a situation, should the reporting entity incur accounting costs to measure the "out of pocket" costs given a reliable estimate can be made, or should the entity eliminate the cost approach from consideration on the grounds of relevance?³

The ED considers two valuation premises:

"A going-concern or in-use valuation premise presumes that marketplace participants would continue to use (a) a business that is a going concern or (b) an asset that is configured for use by an entity. In those situations, a going-concern or in-use valuation premise is generally appropriate. Otherwise, an in-exchange valuation premise may be appropriate. An in-exchange valuation premise presumes that an asset is not configured for use by an entity and that marketplace participants would sell the asset. In either case, the estimate of fair value would consider the related assumptions and data that marketplace participants would use." (para 13).

It appears that, in choosing a valuation premise, a reporting entity must consider what marketplace participants would do rather than what the reporting entity intends to do. What if a reporting believes that an asset is appropriately configured for use by the entity although marketplace participants disagree with this assessment?⁴

Fair Value Hierarchy:

Level 2 estimates are those determined using quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences between the asset/liability used as the benchmark and the asset/liability being fair valued. However, when estimating a Level 2 fair value "the price effect of the differences [between similar assets] must be objectively determinable." (para 20). The ED gives an example of how the fair value of unsecuritized receivables could be based on the observed price of securitized receivables. In order for this to be a Level 2 estimate, the hypothetical price effect of securitization must be objectively determinable. It would be helpful if the ED clarifies what evidence is considered "objective" in order for reporting entities to distinguish between Level 2 and Level 3 estimates. To qualify as a Level 2 estimate, must the price effect be based on observed prices (or quotes) of the elements that make up the difference between the asset being valued (e.g., unsecuritized receivables) and the benchmark asset (e.g., securitized receivables)? Are such prices typically available? If not, could the price effect be based on a valuation model?

The ED states that "a willing buyer that is able to replicate identical software for \$1 million would not pay \$15 million to otherwise acquire it in an exchange transaction." (para B14). This would be the case if there are no barriers to entry (proprietary codes, copyright protection, etc.). However, without any barriers, the software may not be worth \$15 million under the income approach. If the assumption of entry barriers is valid, then the income (out of pocket cost) approach is likely to be more relevant (less relevant), and vice versa. For instance, the investment community and other market participants may uniformly believe that a reporting entity should divest an asset or group of assets.

⁵ For instance, consider a manufacturing company with a portfolio of accounts receivable. Could it estimate the fair value of its unsecuritized receivables based on the estimated value of the price effect of securitization obtained from a financial institution specializing in

A related issue is when does a Level 2 estimate become a Level 3 estimate? How dissimilar must the asset being valued and the benchmark asset be before they fail the "similar assets" test? 6 Could similar assets be defined in terms of the expected comovements in their fair values? 7

When a reporting entity resorts to a Level 3 estimation, "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 without undue cost and effort." (para 21). Consider the following quote from the ED:

"If information necessary to apply multiple valuation techniques is not available without cost and effort, the valuation technique that best approximates what an exchange price would be in the circumstances shall be used." (para 22).

It is not clear why the use of the "best" valuation technique is considered appropriate only when the measurement costs are prohibitive. Shouldn't reporting entities be allowed to choose "the valuation technique that best approximates what an exchange price would be" all the time? While the ED's directive on the use of multiple valuation techniques appears consistent with the requirements in the appraisal profession, the final standard could articulate better the reasons for mandating the use of multiple valuation techniques for a Level 3 estimation.

securitization (or a valuation expert specializing in securitization)? Would that be considered objectively determinable evidence?

⁶ In paragraph B8, the ED uses a singular ("difference") when discussing the concept of "similar assets" and uses a plural ("differences") when discussing assets that would be considered "dissimilar." Does this suggest that a reporting entity must consider an asset as being subject to Level 3 estimation if it differs from the benchmark asset in more than one relevant attribute?

⁷ Has the FASB considered any tests similar to the correlation test used for hedging instruments? One possibility is to consider whether the benchmark asset retains most of the price risk that is likely to impact the fair value of the asset in the future. For instance, while the securitized portion of the receivables may retain the interest rate risk, any residual interests retained by the original holder of the receivables may retain most of the credit risk. In which case, how should a reporting entity determine whether the two assets are similar enough to qualify for Level 2 estimation? Note 20 of the ED appears to suggest that the criteria for defining similar assets would be defined in the accounting standard that requires fair value measurement.

In the context of accrual accounting, some companies may use percentage-of-sales method to estimate bad debts, while some others may use an aging schedule. Some may consider both methods. However, the choice is typically left to the management (and the company auditors) as to which one may be most appropriate for a given company. Similar to bad debts estimation, many accrual estimates are "Level 3 estimates." Therefore, it would be helpful if the ED emphasized the added benefits from requiring reporting entities to use multiple valuation techniques when it comes to fair value estimation.

At a conceptual level, instead of distinguishing the three levels based on information availability, it may be more useful to distinguish them based on the type of market for the asset (or liability) being valued. For instance, instead of using the qualifier that "if quoted prices for identical assets or liabilities in active markets are not available," an alternative would be "if active markets for identical assets or liabilities do not exist." This would emphasis the importance of the existence of markets as a precursor to the existence of relevant information. Along the same lines, Level 3 estimates could be defined in terms of their markets as well: "Level 3 estimates are usually for assets (or liabilities) that are typically entity- or business-specific assets (or liabilities), which are not regularly traded in active markets. Reporting entities are in the business of benefiting from these assets by using them in the normal course of operations or satisfying obligations by discharging the liabilities in the normal course of operations." Such a markets-based definition would also address issues as to when market inputs versus entity inputs may be more appropriate. Consider the following statement in the ED:

"In some cases, market inputs might not be available without undue cost and effort, requiring the use of significant entity inputs derived from an entity's own internal estimates and assumptions." (para 24).

It is very likely that market-based inputs are "costly" to obtain when markets don't exist, and in those cases, the assets are likely to be business- or entity-specific in nature.

Present Value Techniques:

The ED considers scenarios when the discount rate adjustment technique versus the expected present value technique may be more appropriate:

"For a fair value estimate, the present value technique used depends on circumstances relevant to the asset (or liability) being measured. For example, the discount rate adjustment technique may be useful when prices for *similar assets* (or liabilities) with similar uncertainties can be observed in the marketplace. If prices for *similar assets* (or liabilities) cannot be observed in the marketplace, an expected present value technique often will be a more effective measurement tool." (para A8, emphasis added).

Does this imply that the discount rate adjustment technique is appropriate for a Level 2 estimate, but the expected present value technique is for a Level 3 estimate? If so, it would be helpful if there is a clarification regarding this in the final standard.

In terms of the applicability of the discount rate adjustment technique, it is not clear what the ED means by the statement "when prices for similar assets (or liabilities) with similar uncertainties can be observed in the marketplace." As indicated in the ED, this technique is readily applicable when there is consensus on contractual cash flows of the similar assets (e.g., face value of a zero-coupon bond). By observing the current yield-to-maturity (YTM) of a bond (which is based on a observable face value amount), one might be able to estimate the fair value of a similar bond (that is an asset) by discounting its contractual cash flows at a rate based on the YTM of the benchmark bond. By using the YTM, the entity is able to sidestep the need to estimate expected cash flows, and in effect, can jointly consider the effects of default on expected cash

flows (the numerator effect) and the appropriate discount rate (the denominator effect).

However, the ED appears to suggest that the discount rate adjustment technique is also appropriate when there are no contractual cash flows, but "the single, most-likely amount in a range of possible estimated amounts (best estimate)" is available. Unlike the bond example, it is not entirely obvious how one can observe the consensus on what the "best estimate" of future cash flows is. In other words, the observed "price" (e.g., YTM) is likely to be a relevant input to estimate the fair value of a similar asset if the "best estimates" of both assets are based on equivalent methods. It would be helpful if additional discussion is added on the implementation of the discount rate adjustment technique to scenarios where only a "best estimate" of future cash flows is available.

Other comments:

The ED makes limited references to what may be considered generally accepted valuation standards and procedures:

"The Board expects that the provisions of this Statement will be applied together with applicable valuation standards and generally accepted valuation practices, where appropriate." (para B1).

Would a valuation performed by a certified appraiser with a membership in the American Society of Appraisers be considered generally accepted by the proposed standard? Preparers may have to consider these issues when deciding whether to outsource the work of fair value estimation. Is the FASB planning to any guidance on this issue?

Thank you for giving me an opportunity to comment on the ED. If you have any questions, please contact me at (517) 432-8350 or rameshk@msu.edu.

Sincerely,

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⁹ For example, observing a high "YTM" on a similar asset, a reporting entity may decide to choose an "optimistic" best estimate to maximize its fair value. Such an issue wouldn't arise in cases where contractual cash flows are predetermined.