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LETTER OF COMMENT NO. **19**

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File Reference: Proposed FSP FAS 157-c

**Proposed FASB Staff Position No. FAS 157-c, "Measuring Liabilities under FASB Statement No. 157"**

Dear Mr. Golden:

We are pleased to comment on the proposed Financial Accounting Standards Board (FASB or the Board) Staff Position No. FAS 157-c, "Measuring Liabilities under FASB Statement No. 157" (the proposed FSP). We commend the Board for attempting to provide additional clarity regarding the fair value measurement of liabilities in accordance with the requirements of FASB Statement No. 157, *Fair Value Measurements* (Statement 157 or the Statement). The practical application of the concepts in Statement 157 has been a challenge to many constituents, particularly as it pertains to the measurement of liabilities. As noted in the proposed FSP, the fair value measurement of liabilities often embodies a hypothetical transaction because it is based on a transfer notion that generally does not occur in the marketplace. That is, entities typically do not transfer their liabilities as contemplated in Statement 157, but rather extinguish them through settlement with the counterparty. Accordingly, we support the Board's efforts to provide practical guidance intended to clarify the application of the principles in Statement 157 to the measurement of liabilities. However, we are concerned that the proposed FSP appears to change the measurement objective for a liability to a measure that is not consistent with the definition of fair value in Statement 157.

As written, the proposed FSP would seem to fundamentally amend one of the conceptual pillars of Statement 157 (i.e., the notion that fair value is an exit price) instead of merely providing clarifying guidance with respect to the application of the Statement. Paragraph 7 of the proposed FSP states that "the reporting entity may measure the fair value of its liabilities at the amount *it* would receive as proceeds if *it* were to issue that liability as of the reporting date". This guidance implies that the fair value measurement of a liability may be based on a reentry price as opposed to an exit price. It is unclear to us whether this was the Board's intention in issuing the proposed FSP. In our view, additional transparency regarding the Board's intentions with respect to the specific objectives of the proposed FSP will be a critical component to any

meaningful deliberations on this topic. If the Board believes reentry price to be a more appropriate measurement objective for liabilities than exit price, then this should be clearly acknowledged through an amendment to either the definition of fair value in Statement 157 or its scope. Alternatively, if the Board's objective in the proposed FSP was to provide a practicability exception for measuring liabilities, we believe this should be clearly articulated. However, a practicability exception that applies broadly to all liabilities measured at fair value would seem to call into the question the principle underlying the actual measurement objective. If the Board's intention is to provide a practicability exception, we suggest that it consider including language suggested by the FASB staff in an earlier version of the proposed FSP, which noted that the proceeds upon issuance "should be adjusted if the reporting entity concludes that a market participant would demand some other amount in a transfer because the attributes of market participants (other than nonperformance risk) differ from the attributes of the reporting entity".

As the Board continues its deliberations on the proposed FSP, we raise the following areas for consideration.

#### ***Deliberation Process***

Comments made at the November 14, 2007 Board meeting would suggest that some members of the Board may have reservations regarding the measurement of liabilities using Statement 157's definition of fair value. If this is the case, we believe it would be inappropriate for the Board to effectively amend one of the fundamental concepts in a principles-based standard through the issuance of an FSP. Instead, we would suggest an open and transparent discussion by the Board on whether "fair value" as defined in Statement 157 is an appropriate measurement objective for liabilities. Ernst & Young would support such a discussion.

While a reentry price measurement objective for liabilities has some merit, we believe there are a number of issues related to such a determination that warrant further consideration by the Board. It is our belief that many of the issues surrounding the implementation of Statement 157 have less to do with the revised definition of fair value itself, but rather the application of this definition in those instances where the revised measurement objective seems inconsistent with the nature or purpose of the item(s) being measured at fair value. Prior to determining when a measurement objective should be used for a certain class of transactions or financial elements, it is important that the measurement objective be clearly defined and understood. Statement 157 served to accomplish this objective with respect to the "fair value" measurement objective, however, once defined, a separate and distinct question regarding when the measurement objective should be utilized needs to be considered.

When previous Boards concluded on fair value as the measurement object for existing accounting pronouncements, this decision was based on a measurement objective that may have differed (in potentially significant ways) from the objective of a fair value measurement under Statement 157. Consistent with certain of our prior remarks, we believe additional focus assessing whether the revised definition of fair value is consistent with the measurement objective contemplated in the existing literature (as compared to an alternative measurement objective, such as one based on entry price or entity-specific intent) would have been prudent

prior to the issuance and/or effective date of the Statement. Although such an exercise would be consistent with the approach adopted by the International Accounting Standards Board in their fair value project, the Board's recent decision against a full deferral of Statement 157 would seem to indicate such an exercise is unlikely in the near-term. While we recognize the need for timely guidance in this area given that Statement 157 is currently effective for financial liabilities, we believe it is critical for the Board to give appropriate consideration to all of the issues associated with amending the measurement objective for liabilities, if this is in fact the Board's intent. Failure to do so, in our minds, will only increase the likelihood of the need for future "fixes" to the accounting literature and serve to further complicate GAAP. As such, we recommend that the Board make this a priority item on their agenda.

We expect that implementation issues associated with Statement 157 for both financial and nonfinancial items will continue to highlight practical and conceptual issues regarding the application of Statement 157 to various standards that require or permit fair value measurements. This was evidenced by the Board's recent decision to exclude many lease transactions from the scope of Statement 157 through the issuance of FSP No. FAS 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification Measurement under Statement 13" (FSP 157-1). We believe that the Board's approach to dealing with these issues is as important as the decisions reached. In order to preserve the objectives and principles of Statement 157, and avoid the perception of rules overriding these principles, we believe it is important for the Board to clearly articulate how any subsequent decisions regarding the application of Statement 157 are consistent with the Statement's underlying principles.

#### ***Quoted Prices for Identical Liabilities***

We agree that the guidance in paragraph 6 of the proposed FSP would serve to increase consistency in the measurement of liabilities where quoted prices are available, such as a reporting entity's publicly traded debt. However, we believe it would be beneficial for the Board to provide additional clarity with respect to how the bid-ask spread should be considered in valuing liabilities vs. assets. Absent additional clarification, the proposed guidance in footnote 8a to paragraph 15A of Statement 157 could lead to confusion on where within the bid-ask spread liabilities should be measured when the observable quotes used to measure these obligations relate to the exchange of an asset held by the counterparty to the reporting entity. As such, we recommend that the Board clarify how the guidance in paragraph 31 of Statement 157 should be considered in determining the fair value of liabilities for which quoted prices are available.

#### ***Reentry Price vs. Exit Price***

As noted above, we believe the guidance in paragraph 7 of the proposed FSP would be interpreted as allowing for a reentry price to be considered in measuring the fair value of a liability. It appears that the guidance in the proposed FSP is predicated on the presumption that reentry price will equal exit price for liabilities solely because the reporting entity and market participants are deemed to have the same level of nonperformance risk. Other than prioritizing observable inputs, the proposed FSP provides for no considerations (such as exit market or the

characteristics of market participants in the exit market) that should be assessed before determining that reentry price may be used to measure the fair value of a liability in accordance with Statement 157.

We question the presumption that reentry price equals exit price and would argue that these prices may differ with respect to liabilities for a number of reasons. For example, reentry and exit price could not be presumed to be equal in situations where an entity would exit (i.e., transfer) a liability in a different market from that in which the obligation was incurred. This could be the case for dealers who enter into transactions (including liability transactions) in the retail market, but would exit in the inter-dealer market.

In addition, the existence of bid-ask spreads in the market in which the liability (or conversely the asset held by the counterparty to the obligation) trades could result in a difference between a reentry price and an exit price. The bid price represents the price at which a dealer is willing to buy a financial instrument, whereas the ask price represents the price offered by the dealer for the sale of the instrument. Consider a derivative liability transaction whereby an end-user takes a short position in an option that is trading with a bid-ask spread of 15-20 quoted in terms of volatility points (vols). In this example, the end-user would enter the transaction and receive a premium based on the bid price of 15 vols (that is, the price at which the dealer is willing to buy, or go long, the option). Under an exit price model, the end-user would likely record the fair value of this short option at or near the ask price based on 20 vols, as that is the price a dealer would charge to sell, or take on a short position, in the option. As such, the reporting entity would recognize a loss resulting from the difference between the transaction price and the assumed exit price resulting from the bid-ask spread. Conversely, the dealer would recognize a gain. Under the reentry price concept in the proposed FSP however, the end-user could record the fair value of the liability at the bid price, the price it would receive if it were to issue (or re-enter) the transaction at the measurement date and therefore recognize no gain or loss. From the dealer perspective, a reentry price concept would seem to conflict with the practice of recognizing a Day 1 gain on transactions, even in situations where the bid-ask spread is observable. It should also be noted that, even in situations where applied, the mid-market practicability exception in Statement 157 would serve only to reduce this difference, not eliminate it.

Finally, as alluded to above, additional tension surrounding the concept of a reentry price versus an exit price centers around the characteristics of market participants in a reporting entity's exit market. In situations where market participants are determined to be virtually identical to the reporting entity, the presumption that reentry price would equal exit price may be appropriate. However, if market participants in the exit market for a liability are deemed to have different characteristics (excluding nonperformance risk) than the reporting entity, the presumption that reentry price equals exit price would seem questionable. As such, in considering how to address the tension between the exit price of Statement 157 and the proposed FSP's reentry price, the Board may want to consider the types of circumstances in which it may be appropriate for a reporting entity to consider market participants to be virtually identical to themselves and how to reconcile this with the principal market concept.

### ***Different Measurement Objectives for Assets and Liabilities***

As previously noted, in our view, the proposed guidance in paragraph 7 of the FSP (and corresponding addition of paragraph 15B to Statement 157) effectively changes the “fair value” measurement objective for liabilities from an exit price to a reentry price. As a result, the principles underlying the determination of fair value for an asset (exit price) will differ from that of a liability (reentry price). If this was the intention of the Board, we believe additional transparency regarding this decision is warranted, as this would seem to represent an amendment to Statement 157 as opposed to a mere clarification of existing guidance within the Statement. While such a decision may be warranted, sufficient due process surrounding this issue would help to ensure the Board has appropriately considered all of the issues and implications regarding this decision before an ultimate conclusion is reached. For example, derivative transactions represent one area where additional consideration by the Board may be warranted. Different principles for determining the fair value of assets versus liabilities would result in different measurement objectives for a derivative transaction depending on whether the derivative represented an asset or a liability. In this instance, it would seem counterintuitive for different measurement objectives to result in an inconsistent treatment of gains or losses for derivative assets versus derivative liabilities, as discussed above.

In addition, if the Board ultimately decides that a different measurement objective is appropriate for assets versus liabilities, we believe any corresponding guidance should clarify that the measurement objective for liabilities is not “fair value”, but rather another measurement objective to be defined. One of the primary objectives of Statement 157 was to simplify and codify the guidance in GAAP related to fair value measurements by establishing a singular definition for fair value and a consistent framework to be used in applying this definition for financial reporting purposes. We are concerned that recent actions, or proposed actions, by the Board may be seen as being counter to this objective. For example, in issuing FSP 157-1, the Board acknowledged that the term *fair value* as used in Statement 13 will be defined differently than in Statement 157. Likewise, the continued use of the term “fair value” as a reentry price measurement for liabilities in the proposed FSP would further muddle the definition of fair value under Statement 157.

### **Other Considerations**

Paragraph 7 of the proposed FSP states that, in the absence of a quoted price for the identical liability in an active market, the reporting entity *may* measure the fair value of its liability at the amount it would receive as “**proceeds**” if it were to issue that liability at the measurement date. The use of the term “may” in the above sentence would seem to indicate that a reporting entity has a choice to measure the fair value of a liability at either exit price or reentry price. However, the option concept alluded to through the use of the word *may* appears to be inconsistent with the requirement to prioritize observable inputs over unobservable inputs in determining whether to use the proceeds it would receive upon issuance at measurement date. We suggest the Board

clarify its intention regarding the interaction of these points. Additionally, it is unclear to us why the proposed FSP uses the term proceeds instead of price, as is used in the definition of fair value in Statement 157. Without further clarification, we believe the term proceeds may be interpreted differently by various constituents. For example, Statement 157 is clear that price should not be adjusted for transaction costs; however it is unclear whether the term proceeds is intended to represent cash flows net of transaction costs. Additional clarification regarding whether proceeds implies cash flows received solely at the measurement date or future cash flows as well (discounted or undiscounted) would also be useful.

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We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

*Ernst + Young LLP*