7 September 2010

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Proposed Accounting Standards Update, “Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs” (File Reference No. 1830-100)

Exposure Draft, “Measurement Uncertainty Analysis Disclosure for Fair Value Measurements”

Dear Mr. Golden:

We appreciate the opportunity to comment to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), or collectively “the Boards,” on Proposed Accounting Standards Update to Topic 820, Fair Value Measurements and Disclosures, “Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs” (the proposed ASU). Our letter also addresses the questions raised by the IASB in its Exposure Draft, “Measurement Uncertainty Analysis Disclosure for Fair Value Measurements” (the ED). (Please refer to Questions 7 and 8 in Appendix A for our responses to the questions posed by the IASB in the ED.) Unless indicated otherwise, the comments provided in our letter apply generally to the proposed International Financial Reporting Standard, Fair Value Measurement, as well as the proposed ASU, given the Boards’ stated objective of deliberating all responses received jointly.

We applaud the Boards’ efforts to develop common requirements for measuring fair value and disclosing information about fair value measurements under US GAAP and IFRS. We believe that fair value should have the same meaning in both US GAAP and IFRS and that the requirements regarding the determination of fair value, and the related disclosures about these measurements, should also be the same. As such, the Boards’ efforts will help promote the comparability of fair value measurements.

We generally support the proposed ASU’s amendments to Topic 820, Fair Value Measurements and Disclosures (ASC 820), observing that many of the proposed amendments would eliminate unnecessary wording differences and clarify the Boards’ views on how the fair value measurement principles should be applied. However, while the FASB observed that it did not intend for many of the proposed amendments to change existing practice under US GAAP, we have noted several potentially significant changes to practice that give us concern. These concerns, which are discussed in detail in our responses to the Questions for Respondents (located in Appendix A of this letter), include:

- The potential recognition of Day 1 losses whenever the transaction price includes a control premium but the unit of account is deemed to be the individual financial instrument
The elimination of the value maximization concept for financial instruments in many instances

The possibility for certain of the proposed amendments to create unnecessary diversity in practice absent additional clarification by the Boards

Many of our concerns stem from the proposed ASU’s heavy reliance on the unit of account guidance from other parts of the accounting literature. Much of that guidance was established prior to the Boards’ conclusion that fair value represents an exit price and, in our view, is often unclear. (The exit price notion was not finalized by the FASB until the issuance of Statement No. 157, Fair Value Measurements, in September 2006 and is being adopted by the IASB only as part of this Fair Value Measurement project.)

By clarifying that the concepts of “highest and best use” and “valuation premise” apply only to nonfinancial assets, the proposed ASU would effectively eliminate the “unit of valuation” notion for financial instruments (unless they qualify for measurement on a portfolio basis, an exception to the fair value principles). As such, the proposed ASU would put additional pressure on the unit of account guidance in other accounting topics. As indicated in previous comment letters, we believe the Boards need to revisit the unit of account guidance throughout their respective accounting literature to determine whether that guidance is clear and the financial reporting effects are consistent with the Boards’ fair value measurement objectives. While this exercise may need to be completed subsequent to issuing a final fair value measurement standard, we believe certain clarifications are needed immediately (for example, to investment company accounting under US GAAP, as discussed in our response to Question 6 in Appendix A).

In addition, we have concerns related to the proposed “measurement uncertainty” disclosure requirements. We believe meaningful, transparent disclosures regarding fair value measurements enhance investor confidence in financial reporting and, therefore, we generally support the Boards’ effort to improve upon the existing fair value disclosure requirements for Level 3 measurements. However, in our view, there are a number of issues that need to be addressed to ensure that these disclosures result in meaningful information to financial statement users. We recommend that the Boards consider an alternative disclosure requirement that focuses on the sensitivity of Level 3 measurements to unobservable inputs, rather than on management’s judgment in determining where fair value falls within a range of values. Refer to our responses to Questions 7 and 8 in Appendix A for further discussion.

We also observe that notwithstanding the Boards’ convergence efforts in this area, several significant differences exist between US GAAP and IFRS that should be addressed. For example, “Day 1” gains and losses (which occur when fair value is different from the transaction price) may generally be recognized in US GAAP but under IFRS only when the inputs are observable. We understand that the IASB has concluded that the issue of whether to recognize a Day 1 gain or loss was beyond the scope of its Fair Value Measurement project, and as such believes the guidance in other IFRSs (such as IAS 39, Financial Instruments: Recognition and Measurement) should continue to be followed. The measurement of investments in investment companies using net asset value (NAV) as a practical expedient under US GAAP represents another significant difference with IFRS. We believe that if the Boards are truly seeking convergence with respect to fair value measurements, the IASB should address these issues in a timely manner.
As noted in our 3 September 2010, comment letter to the International Valuation Standards Board (IVSB) on its proposed *International Valuation Standards*, we believe the IASB and the IVSB should jointly develop guidance that will bridge the gap between valuation standards and fair value accounting standards. Please refer to our comment letter for additional discussion on this point.

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We would be pleased to discuss our comments with members of the Boards or the FASB/IASB staff at your convenience.

Very truly yours,

Ernst & Young LLP
Appendix A

Question 1

This Exposure Draft represents the Board's commitment toward developing common fair value measurement guidance with the IASB. Do you think the proposed amendments:

a. Would improve the understandability of the fair value measurement guidance in U.S. GAAP? If not, why not?

b. Would result in any unintended consequences on the application of the proposed amendments? If so, please describe those consequences.

Understandability

We believe that while most of the amendments in the proposed ASU would improve the understandability of the fair value measurement guidance in US GAAP, certain amendments require additional clarification. Among the clarifications needed, the proposed ASU indicates that a fair value measurement contemplates the price that would be received for the sale of the asset alone (based on its unit of account), and not as a group of assets (even when the asset is to be used in conjunction with other assets). Consider a situation where the complementary asset(s) used in conjunction with the asset being measured are unique to the reporting entity. In this situation, because the complementary assets are not held by (and likely could not be obtained from) other market participants, it is unclear to us whether the proprietary complementary assets may be considered in estimating the fair value of the standalone asset.

The proposed ASU's indication that complementary assets and liabilities should be assumed to be available to market participants is confusing to us because it blurs the distinction between fair value (which is a market-based measurement) and entity-specific value. That is, entity-specific synergies become difficult to identify if one should assume that market participants have access to the reporting entity's complementary assets or liabilities.

In addition, the proposed guidance does not indicate how the cost of obtaining these complementary assets or liabilities would affect the fair value measurement. We recommend the Boards clarify how the assumption that complementary assets and liabilities are available to market participants is to be applied, particularly in those cases where the assets are unique and therefore generally not available to market participants.

Also, we do not believe the proposed ASU is clear when and how "complementary liabilities" should be considered in valuing a nonfinancial asset. When measuring the fair value of a nonfinancial asset, the proposed ASU acknowledges that the highest and best use of the asset may be through its use in combination with other assets and liabilities. While liabilities that fund working capital are cited as an example of liabilities that may be considered when measuring the fair value of a nonfinancial asset, the proposed ASU provides no basis for determining when liabilities may (or should) be considered.
The Boards should provide additional guidance or an illustrative example to further explain this concept.

The Boards should also consider addressing the question of whether complementary assets may be considered in measuring the fair value of a nonfinancial liability. For example, it is unclear to us whether, in measuring the fair value of an asset retirement obligation (ARO), it is appropriate to assume that the market participant to whom the liability would be transferred would have control of the asset associated with the retirement obligation.

**Potential unintended consequences**

We have significant concerns that the proposed ASU would result in the recognition of Day 1 losses for items measured at fair value whenever the transaction price includes a control premium but the unit of account is deemed to be the individual financial instrument. The proposed guidance is clear that the Boards believe blockage factors, like transaction costs, are specific to the entity (not to the asset or liability), and will differ depending on how an entity enters into a transaction for the asset or liability. That is, the Boards believe the determination whether a reporting entity has a blockage factor is entity-specific and thus should not be reflected in a fair value measurement because it is based on whether the reporting entity decided to enter into a block transaction.

It is unclear to us whether (and, if so, why) the Boards believe that, similar to a blockage factor, a control premium paid is an entity-specific decision that should result in the recognition of a Day 1 loss when the unit of account is the individual financial instrument. Entities are often required to pay a premium to acquire a controlling interest in another entity. While the accounting model typically requires the acquirer to consolidate these controlled entities, investment companies measure these interests at fair value under US GAAP. Unless the unit of account is determined to be the controlling interest, an investment company that pays a control premium would recognize a Day 1 loss on this transaction, as the fair value of its investment would be determined on a non-controlling basis. Recognizing a loss for the control premium paid does not promote high quality financial reporting.

It appears to us that the Boards' view permits control premiums to be considered in a fair value measurement as long as the unit of account is the controlling interest and market participants would consider such a premium in pricing the asset. In our view, relying on the unit of account guidance in other accounting areas—which was established prior to the Boards' conclusion that fair value represents an exit price—to determine whether a control premium should be considered seems arbitrary and potentially inconsistent with market participants' assumptions. Refer to our responses to Questions 2 and 6 for additional discussion on this point where we also provide the Boards with our recommendations on how this issue should be addressed.

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1. Whether such a control premium exists for all entities, or is instead viewed as a transaction-based premium that relates only to those entities that are actually acquired, is the subject of ongoing debate.

2. The comments in our letter regarding investment company accounting under US GAAP may also be applicable under IFRS when a reporting entity accounts for investments in subsidiaries, jointly controlled entities and associates, in separate financial statements, at fair value as provided for in IAS 27, Consolidated and Separate Financial Statements (IAS 27).
Question 2

The Board has decided to specify that the concepts of highest and best use and valuation premise are only to be applied when measuring the fair value of nonfinancial assets. Are there situations in which those concepts could be applied to financial assets or to liabilities? If so, please describe those situations.

We agree that the terms “highest and best use” and “valuation premise” are best used in the context of valuing nonfinancial assets; many have found these terms confusing because financial instruments are not generally thought of as being “used.” As such, we agree with the Boards’ decision to clarify that these terms should not be applied to financial instruments and liabilities. We believe the more important issue, however, is how and whether the concept underlying these terms should be applied to financial instruments. We believe this underlying concept to be one of “value maximization,” which would apply to all fair value measurements, including financial assets and liabilities. Simply stated, we believe that in measuring fair value, it should be assumed that market participants will act to maximize the value of most business enterprises, including profits or net assets, and market participants will transact consistently with this objective.

We believe the value maximization concept is important because it helps address the gaps between the unit of account guidance provided for in other areas of accounting and the unit of valuation concept regarding how market participants would actually transact for certain assets and liabilities, including financial assets and liabilities. For example, market participants that own a controlling interest in another entity would generally not be expected to maximize value by individually selling the shares of the entity. Instead, they would likely sell the controlling interest in order to maximize the proceeds received upon any sale. By stating that the concepts of highest and best use and valuation premise do not apply to financial instruments, without regard for the underlying concept of value maximization, we believe the FASB has effectively eliminated the “unit of valuation” notion for these instruments, thereby requiring them to be measured based solely on their units of account.

Importantly, because the unit of account for financial instruments is generally the individual instrument, we believe that in certain situations fair value measurements under the proposed ASU would inappropriately exclude the concept of value maximization, thereby reducing the quality of the measurement. To illustrate our concern, consider an investment company that owns all of the debt and equity of a portfolio company. Many entities currently view the debt and equity as one unit of valuation based on the concepts of highest and best use and valuation premise. That is, they assume that the debt and equity would be sold to the same market participant because that transfer would maximize value.

As a result, the combined fair value of the debt and equity equals the controlling enterprise value of the portfolio company. Under the proposed ASU, entities would not be able to view the debt and equity as one unit of valuation, and, assuming the debt and equity are considered separate units of account with different exit markets, the combined fair value of these instruments would likely be less
than the controlling enterprise value. Our response to Question 6 elaborates on our concern and includes a numerical illustration.

Question 3

Do you agree with the proposed guidance for measuring the fair value of an instrument classified in shareholders' equity? Why or why not?

We agree with the proposed guidance to measure the fair value of an instrument classified in shareholders' equity, which is based on the perspective of a market participant who holds the instrument as an asset. From a conceptual standpoint, the proposed guidance implicitly assumes that the exit market for a reporting entity's own equity is the same as for the instrument held as an asset by market participants. While this assumption may not necessarily be true, absent this practical guidance, constituents have struggled to apply the exit price notion to their own equity instruments.

While we support the proposed amendment, we believe the final standards should clarify how a reporting entity would consider the bid-ask spread in estimating the fair value of its equity instrument. Absent clarifying guidance, some constituents may determine it is appropriate to measure their own equity instruments using a bid price for the corresponding asset. In addition, we recommend that any finalized guidance explicitly state whether a reporting entity should adjust the fair value of the equity instrument for the effect of any restriction on the corresponding asset.

For example, with respect to measuring liabilities using the price of a corresponding asset, the guidance in ASC 820-10-35-16DD indicates that a reporting entity would not adjust the price of the corresponding asset to exclude the effect of a restriction preventing the sale of the asset. That is, absent other factors, ASC 820 indicates that the fair value of a liability would equal the price of the restricted asset. We believe a similar clarification is warranted for instruments classified in shareholders' equity.

Question 4

The Board has decided to permit an exception to fair value measurement requirements for measuring the fair value of a group of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to a particular market risk (or risks) (that is, interest rate risk, currency risk, or other price risk) or to the credit risk of a particular counterparty.

a. Do you think that proposal is appropriate? If not, why not?

b. Do you believe that the application of the proposed guidance would change the fair value measurements of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to those risks? If so, please describe how the proposed guidance would affect current practice.
We agree with the Boards’ decision to permit an exception to the fair value measurement principles allowing qualifying financial assets and liabilities to be measured on the basis of their net exposure to a particular risk, instead of the exit price for the individual financial assets or liabilities themselves. We believe the proposed guidance is largely consistent with existing practice under both US GAAP and IFRS, particularly as it pertains to determining valuation adjustments related to bid-ask spreads and credit risk in the fair value measurement of derivative instruments. For example, the proposed guidance would permit reporting entities to continue offsetting credit risk at the counterparty level (e.g., based on its portfolio of interest rate swaps with a particular counterparty) while offsetting market risks on a more aggregated portfolio basis (e.g., based on its portfolio of interest rate swaps with all counterparties).

However, because the exception would be permitted only for financial instruments with offsetting risks, entities that use the in-use valuation premise to measure certain financial assets (such as homogeneous loans) on a portfolio basis may be affected. Given the potential change to current practice under US GAAP, we believe the FASB should provide additional application guidance on factors constituents should consider in measuring financial instruments that do not have offsetting risks, but that are typically held as part of a portfolio. For example, the proposed guidance is unclear whether a reporting entity measuring an individual financial asset that is typically held in a portfolio could assume that the asset is to be sold to market participants that have a diversified portfolio of similar products thereby incorporating the benefits of diversification (as was discussed by the IASB in its 2009 Exposure Draft, Fair Value Measurement).

We believe this guidance is needed to promote the comparability of fair value measurements, as we understand many constituents believe that in measuring fair value, the exit markets and market participants for a portfolio of financial assets and a single financial asset would differ.

**Criteria to apply measurement exception**

While we support the measurement exception, we believe the Boards should clarify the requirements for its use. For example, it is unclear to us what it means to “manage a group of financial instruments on a net exposure basis.” Should this requirement be viewed from the perspective of how the entity analyzes its exposures for risk management purposes or does it instead consider how the entity transacts for the instruments (e.g., the entity manages risk by entering into transactions with offsetting risks, as opposed to settling the individual financial asset or liability)? We also found the requirement that an entity must manage its net exposure on a consistent basis from period to period to be confusing. As the amount of risk an entity is exposed to can clearly vary from period to period, is the entity simply required to use a consistent technique to assess its net exposure from one period to the next?

The proposed ASU also indicates that the reporting entity must manage the group of financial assets and financial liabilities on the basis of the reporting entity’s net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the reporting entity’s documented risk management or investment strategy. This would seem to imply that a reporting entity could utilize the practical expedient even if it manages only one of several market risks included in the portfolio of financial instruments on a net exposure basis. That is, for a particular portfolio that includes both interest rate and foreign currency risks, a reporting entity could be permitted to determine its bid-ask valuation adjustment for interest rate risk on a net basis, while calculating its valuation adjustment for foreign currency risk on a gross basis. If this is the Boards’ intention, we believe they should state this explicitly.
Other clarifications regarding the application of the measurement exception

We believe the Boards should clarify whether it is appropriate to consider the aggregate size of an entity's net open position in determining the fair value of a particular risk exposure under the measurement exception provided in the proposed ASU. ASC 820-10-35-18I states that the exception permits a reporting entity to measure the fair value of a group of financial assets and liabilities on the basis of the price that would be received to sell a net long position (or to transfer a net short position) for a particular risk exposure. One may reasonably conclude that a discount on a net exposure position should be included in a fair value measurement if market participants would include such a discount when transacting for an exposure of that size. However, this interpretation seems contrary to the Boards' general view on blockage discounts. Therefore, we suggest the Boards address this issue in any final guidance. (Refer to Question 5 for additional discussion.)

In addition, we understand that many constituents are confused as to whether Level 1 financial instruments the reporting entity manages on a net exposure basis qualify for use of the measurement exception. For example, when a reporting entity manages its interest rate risk on over-the-counter forwards and swaps by entering into exchange-traded futures (whose prices are quoted on active exchange), these constituents believe the offsetting risk provided by the futures should be considered in determining the entity's net exposure to interest rate risk for purposes of applying the exception. The guidance in ASC 820-10-35-18M of the proposed ASU would seem to indicate the Boards' belief that, as a Level 1 measurement, the exchange-traded futures contracts should be measured based on the quoted exchange price without adjustment and therefore could not be considered in determining the reporting entity's net exposure to interest rate risk. To avoid confusion and the potential for divergent views, if this is in fact the Boards' intention, we recommend this point be made explicitly clear in any final standards.

Portfolio level adjustments

We believe the Boards should address the issue of allocating permitted portfolio level adjustments to the appropriate units of account required in other accounting topics. For example, while the measurement exception may be used to estimate the fair value of a portfolio of derivative contracts with offsetting risks (e.g., interest rate risk and credit risk), the unit of account under ASC 815, Derivatives and Hedging, remains the individual derivative contracts. As such, hedge effectiveness would still need to be assessed at the individual derivative level.

We also believe that the fair value hierarchy disclosures required under ASC 820 are made at a level consistent with the unit of account for the asset or liability measured at fair value. Therefore, when the measurement exception is used to value financial instruments with offsetting risks, it would seem that the portfolio level fair value would need to be allocated to the unit of account. We believe that the Boards should make it clear in any finalized guidance that when fair value is determined using the measurement exception, allocation of this value to the appropriate unit of account would be necessary when other accounting requirements are performed at a more disaggregated level (e.g., hedge effectiveness testing or classification within the fair value hierarchy). However, we would not expect the Boards to prescribe any specific methods for allocation.
Question 5

The Board has decided to clarify the meaning of a blockage factor and to prohibit the use of a blockage factor when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). Do you think that proposal is appropriate? If not, why not?

Blockage factors and other discounts

While clarifying the meaning of a blockage factor will help differentiate this concept from other types of discounts and premiums that may be considered in a fair value measurement, we believe that the Boards should specify how a blockage factor differs from a discount for lack of marketability, as well as discounts that may be associated with the size of an individual financial instrument. Notwithstanding the description of a blockage factor, we believe there may be confusion regarding these concepts because ASC 820 is clear that a fair value measurement should consider the characteristics of the asset or liability being measured. As such, a discount may be appropriate when measuring the fair value of an individual financial instrument that has an extremely large principal or notional value when compared to market norms for that type of contract.

To illustrate, consider two entities: one has a derivative contract with a notional amount of $1 billion, which is significantly larger than the market norm, and the other has 100 similar derivative contracts (whose risks are not offsetting), each of which has a notional of $10 million that is consistent with the market norm. In this case, although the two entities have similar exposures (ignoring credit risk), a discount could be considered in determining the fair value of the $1 billion derivative contract, but a block discount could not be used in measuring the fair value of the 100 derivative contracts. Because these concepts may be misinterpreted in practice, the Boards should further clarify the distinction between these types of discounts and consider providing an illustrative example.

Prohibition on use of blockage factors

ASC 820 currently prohibits the use of blockage factors only for Level 1 measurements, which many constituents view as a rule in an otherwise principles-based standard. In addition, they believe this rule is conceptually inconsistent with a fair value measurement model that contemplates an exit price for assets and liabilities as of the measurement date. That is, even when the unit of account is deemed to be the individual financial instrument, many would expect the quoted price for the instrument to change if the entity were to eventually “sell” all of its individual units in separate transactions on the measurement date.

We believe these concerns raise an important and fundamental question about the fair value framework that the Boards should explicitly address in any finalized guidance. While the guidance clearly contemplates hypothetical transactions on the measurement date, it is unclear whether any ramifications of the aggregate hypothetical transactions should also be considered. Stated differently, when the unit of account is determined to be the individual financial instrument, does a fair value measurement consider the reporting entity’s other holdings, resulting in a reported fair
value that could actually be achieved by the entity in a hypothetical sale of all of its assets as of the measurement date? Or instead, is the fair value framework simply an accounting construct used as a means to arrive at a market-based measurement for financial reporting purposes, but that would not consider the ramifications of actual sales on the measurement date?

We believe this clarification has direct implications to fair value measurements other than blocks, including equity investments in entities whose outstanding debt obligations contain change in control provisions (which is a common feature). Under current practice, many investment companies value their equity interests (unless determined to be Level 1 measurements) on a controlling basis and assume the change in control provision on the debt would be triggered (including any prepayment penalties) on the hypothetical sale of the controlling equity interest. If these interests are instead to be measured on a noncontrolling basis, the standards should provide a principle that clearly addresses whether the change in control provisions would be contemplated in the hypothetical sale of all of the entity's equity interests on an individual basis as of the measurement date.

Assuming the Boards clarify (i) the difference between a blockage factor and the discount for lack of marketability or the size of an individual financial instrument and (ii) that the fair value framework does not consider the ramifications of the actual sale of separate units of account, we do not have any specific conceptual objection to the decision to prohibit the consideration of blockage factors. However, this prohibition will likely pose certain operational challenges for preparers as Level 2 and Level 3 fair value measurements must be performed on an individual instrument basis instead on an aggregate basis. It also will require entities to distinguish the liquidity adjustment that is specific to the inactivity of the market for the particular instrument (based on its unit of account) from any adjustment related to the aggregate size of the entity's position.

Question 6

The Board has decided to specify that other premiums and discounts (for example, a control premium or a noncontrolling interest discount) should be taken into account in fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy when market participants would take into account those premiums or discounts when pricing an asset or a liability consistent with the unit of account for that asset or liability.

a. Do you think that proposal is appropriate? If not, why not?

b. When the unit of account for a particular asset or liability is not clearly specified in another Topic, how would you apply that proposed guidance in practice? Please describe the circumstances (that is, the asset or liability and the relevant Topic) for which the unit of account is not clear.

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1 This view would seem to be supported by the IASB staff's Agenda Paper 26 on measuring liabilities at fair value, which noted in paragraph 5 that "a fair value measurement does not assume that the reporting entity actually transfers the liability. It is simply a way to arrive at an objective, market-based price at a particular measurement date."
**Premiums and discounts**

We believe that other premiums and discounts (such as a control premium) should be reflected in a fair value measurement if market participants would consider those premiums or discounts in pricing an asset or a liability. Further, as previously discussed, we believe the determination of whether a control premium should be included in a fair value measurement should consider the concept of “value maximization,” and should not be limited solely by unit of account guidance in other accounting topics (or in ASC 820 itself, as is the case for Level 1 measurements).

For example, although prohibited currently under the guidance in ASC 820, we do not believe that an investment company that acquires 90% of a publicly-traded company should be prohibited from considering a control premium in measuring the equity interest’s fair value. Measuring this investment for accounting purposes based on the publicly-traded share price for the individual shares is, in our view, inconsistent with the value maximization objective of market participants. We believe the accounting in this instance - the recognition of a Day 1 loss upon acquiring the controlling interest - produces a result that is inconsistent with the transaction’s underlying economics, and is therefore less relevant. We understand that the Boards value the reliability and comparability that comes from measuring Level 1 instruments based solely on the quoted price for the individual share. While we agree that the reliability of information can impact its usefulness, we believe information must always be relevant (i.e., reflect the economics of the transaction it is purporting to reflect) to be decision-useful.

**Unit of account guidance**

As previously noted, we believe the Boards need to reassess the unit of account guidance that currently exists in their respective literature to determine whether it is clear, is adequate, and produces outcomes that are consistent with the Boards’ fair value measurement objectives. In particular, we believe that the unit of account guidance in ASC 946, *Financial Services - Investments Companies*, is unclear. ASC 946-320-35-1 states only that “an investment company shall measure investments in debt and equity securities subsequently at fair value” which does not indicate whether the unit of account is an individual share or an aggregate position of all of the shares held by the investment company (which could represent a controlling interest). In practice, we believe some constituents view the unit of account to be the individual shares as this is consistent with the guidance for financial instruments generally (although currently the aggregate shares are typically considered to be the “unit of valuation” unless traded in an active market) and could be viewed as more consistent with the Boards’ thinking on blockage factors.

Given the proposed amendments, we believe the FASB must clarify the unit of account guidance for investments in debt and equity securities held by investment companies. (A similar clarification by the IASB is needed for investments in subsidiaries, jointly controlled entities and associates that are measured at fair value in separate financial statements, as provided for in IAS 27.) Many of the current practice issues regarding control premiums are specific to these types of entities given they do not consolidate controlled investees. These practice issues will only intensify given that the proposed ASU effectively eliminates the “unit of valuation” concept for financial instruments.

Further, it would be helpful if the FASB clarified the unit of account for investment companies that hold both debt and equity securities of the same portfolio company. Appendix B to this letter
illuminates the changes to existing practice we believe would occur upon the adoption of the proposed guidance absent further clarification by the Boards.

**Question 7**

The Board has decided to require a reporting entity to disclose a measurement uncertainty analysis that takes into account the effect of correlation between unobservable inputs for recurring fair value measurements categorized within Level 3 of the fair value hierarchy unless another Topic specifies that such a disclosure is not required for a particular asset or liability (for example, the Board has decided in its project on the accounting for financial instruments that a measurement uncertainty analysis disclosure would not be required for investments in unquoted equity instruments). Do you think that proposal is appropriate? If not, why not?

**Measurement uncertainty disclosures**

While we generally support the Boards’ effort to improve the transparency of Level 3 measurements, we have a number of concerns with the proposed measurement uncertainty analysis. Many of these concerns were discussed in our comment letter dated 12 October 2009, in response to the FASB's proposed ASU, “Improving Disclosures about Fair Value Measurements” (ASU 2010-06), as the measurement uncertainty disclosures in this proposed ASU are very similar to the “sensitivity” disclosures proposed by the FASB in ASU 2010-06. These concerns include:

- The determination of other unobservable inputs that could have been reasonably used in the Level 3 measurement is very subjective and therefore likely to result in disparate views among preparers.

- The proposed measurement uncertainty disclosures appear to be focused more on assessing management’s judgment in determining where fair value falls within a range of values rather than on the sensitivity of Level 3 measurement to changes in unobservable inputs.

- While we understand the theoretical appeal of such information in assessing an entity’s quality of earnings, we believe that disclosing a range of other “acceptable” values that could have been recorded by the entity as of the measurement date could be confusing. Assessing various indications of value and determining the point estimate that is deemed to be the most representative of fair value is judgmental and frequently complex. Often, certain unobservable inputs or indications of value will be determined to be less relevant than others based on facts and circumstances specific to the particular asset or liability being valued. Disclosing the specific facts and circumstances related to the various classes of Level 3 measurements does not seem practical. However, absent such clarification, we are concerned that users may improperly conclude that all amounts within the range of value disclosed are equally representative of fair value.

- Some preparers have expressed concerns that the approach outlined in the proposed ASU could have a detrimental competitive effect and introduce potential litigation and regulatory risks. These constituents note that the proposed disclosures seem to expose management to considerable “second guessing” on the measurements used for financial reporting, despite the
fact that the FASB indicates in paragraph BC 63 of the Basis for Conclusions in the proposed ASU that this is not the intent of the disclosure.

- We believe there are a number of operational challenges associated with the proposed disclosures.

- In many instances the consideration of other alternative unobservable inputs may not be part of an entity's current valuation procedures. Additional complexities stem from the level of transparency regarding specific unobservable inputs that would be available to constituents that utilize third-party pricing services and brokers in determining fair value. While constituents are required to understand the valuation methodologies and inputs used by pricing services and brokers to develop pricing information and assess the information they receive to ensure it is appropriate for financial reporting purposes, it is our understanding that few constituents have the ability to evaluate the individual inputs used by these third parties.

- While we understand that this disclosure (absent consideration of correlation) is currently required under IFRS 7, Financial Instruments: Disclosures, there is significant diversity in practice regarding how the disclosures are made. It is our understanding that few companies disclose information in a manner consistent with the illustrative example in the proposed ASU.

To address these concerns, we suggest that the Boards consider an alternative approach, which is discussed in our response to Question 8.

Clarifications to the illustrative example

We believe additional guidance is needed with respect to the measurement uncertainty disclosures. The illustrative example provided in ASC 820-10-55-77 through 55-81 regarding the measurement uncertainty disclosures does not provide any insight on how the entity determined the effect of changing unobservable inputs or how correlation was considered. While we recognize that significant judgment will be required in making these determinations, we believe some application guidance would help convey the Boards' intent regarding how the objective of the disclosure should be achieved.

Based on the diversity in practice that currently exists in how constituents interpret these requirements under IFRS 7, we think this additional clarity is essential to foster comparable disclosures among reporting entities. In addition, we believe the Boards should explicitly state whether the reporting entity is expected to disclose the range of current inputs used in determining fair value and what those inputs were changed to or only the effect of the change. Based on the illustrative example, it would appear that disclosing the range of actual inputs used and what they were changed to is not required, and as such will likely not be provided by constituents in this disclosure.

The proposed ASU also clarifies that the measurement uncertainty disclosure is required only when changing one or more of the unobservable inputs used to other reasonable inputs would result in a significantly higher or lower fair value measurement. While the proposed guidance states that significance is to be judged with respect to earnings and total assets or liabilities (or with respect to total equity if change in fair value is recognized in other comprehensive income), it is unclear whether this assessment is to be made at the individual instrument level, for all level 3 instruments
within the class of assets or liabilities disclosed, or in aggregate across all Level 3 measurements for the reporting entity. To avoid diversity in practice, we believe that the Boards should clarify that the assessment of significance should be made for each class of assets or liabilities that contain Level 3 measurements.

Consideration of correlation
Regardless of whether the Boards move forward with the proposed measurement uncertainty disclosures or pursue an alternative approach, we agree that incorporating the expected effects of correlation among the various unobservable inputs used provides meaningful information. In our view, the decision-usefulness of the proposed disclosures (or potential alternative approaches) is greatly diminished when changes to individual unobservable inputs in a valuation technique are considered in isolation of other interrelated inputs. Such an approach results in amounts that are not representative of the true expected change in the fair value of the asset or liability if other alternative unobservable inputs were used.

In addition, although stated in the Basis for Conclusions of the proposed ASU and the ED, we believe the final standards themselves should clarify that use of the term "correlation" does not imply that any sort of statistical analysis is required to validate the strength of the relationship between unobservable inputs.

Scope exceptions from the measurement uncertainty disclosures
We believe the FASB's decision to exclude unquoted equity investments from the measurement uncertainty disclosure analysis is appropriate. Given the unique nature of each individual investment and the significant number of unobservable inputs used to determine fair value, we believe it would have been difficult for constituents to meet the disclosure requirements for these instruments. However, we recommend that the FASB clarify that this scope exception applies to unquoted equity investments in entities such as hedge funds and private equity funds. While it appears that these investments would be in the scope exception provided, the inclusion of investments in hedge funds, private equity funds, and venture capital funds in the illustrated example provided in ASC 820-10-55-80 of the proposed ASU makes this unclear.

In particular, requiring the measurement uncertainty disclosures for these types of investments when NAV is used as a practical expedient to measure fair value seems inappropriate. In these instances, the classification of these investments as Level 3 measurements is primarily based on the entity's inability to redeem the investment at NAV, either at the measurement date or in the near term, not the inputs used to determine NAV (as the unit of account is the reporting entity's interest in the investee not the underlying assets held by the investee). One of the reasons this practical expedient was provided for in ASC 820 was due to the difficulty constituents had in quantifying the effect of these restrictions on the fair value of the investment. As such, expecting constituents to provide a range of values regarding the effect of these restrictions seems counterintuitive to the purpose of the practical expedient. In addition, ASC 820 already contains specific disclosure requirements related to these investments that are intended to help users better understand the nature and risk of these investments.

Additionally, we observe that the scope exclusion for unquoted equities is provided for in the FASB's Exposure Draft on accounting for financial instruments, which may not become effective until after the measurement uncertainty disclosures in the proposed ASU are required. As such, we
recommend the FASB make it clear to constituents that regardless of the date the financial instruments guidance becomes effective, the measurement uncertainty disclosures are not required for investments in unquoted equities. We also strongly recommend that the IASB provide a similar scope exception for unquoted equities (as clarified in our comments above) in its required disclosures as we believe the operational concerns and cost-benefit considerations contemplated by the FASB in reaching its decision to exclude these instruments are also relevant under IFRS.

Question 8

Are there alternative disclosures to the proposed measurement uncertainty analysis that you believe might provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorized within Level 3 of the fair value hierarchy that the Board should consider instead? If so, please provide a description of those disclosures and the reasons why you think that information would be more useful and more cost-beneficial.

We suggest that the Boards consider an alternative approach to disclose the magnitude by which an entity’s Level 3 fair value measurements would change given a predefined change in a significant assumption (e.g., 5%). For example, an entity could disclose the change in fair value of a class of its residential mortgage-backed securities (RMBS) that would result from a 5% change in the weighted-average probability of default assumptions used in its valuation model. Under this approach, the other unobservable inputs used in the valuation of the entity’s RMBS portfolio would be adjusted for movements that would be commensurate with a 5% change in probability of default assumptions considering the relationship of these inputs to default rates (i.e., consideration of correlation).

This approach would provide financial statement users with additional information on how sensitive the entity’s Level 3 measurements are to unobservable inputs without implying an alternative range of values that could have been recorded in the financial statements. Providing this type of information to financial statements users would enable them to make their own assessment as to the potential range of fair value for Level 3 measurements, given their own views on the inputs used in the valuation.

In our view, predefining the change in unobservable inputs would eliminate the subjectivity and many of the potential operational difficulties with respect to the determination of reasonable possible alternative inputs. In addition, while not necessarily reducing the complexity of the calculation, such an approach would help address preparer concerns about “second guessing” management’s judgment.

Other disclosure requirements

We also have the following broad comments related to the disclosure requirements in the proposed ASU and ED.

Scope of disclosures under IFRS
The proposed ASU indicates that the disclosure requirements under US GAAP will differ from the disclosure requirements under IFRS, noting that “IFRSs do not distinguish between recurring and
nonrecurring fair value measurements." While this may be true, we find the scope of the fair value disclosure requirements under IFRS to be confusing. For example, while the recognition of impairment under IAS 36, Impairment of Assets (IAS 36), is not necessarily at fair value, it is not clear whether the IASB intends the fair value measurement disclosures to apply when the recoverable amount is determined based on the asset's fair value less cost to sell.

In our view, it would seem appropriate for an entity to make the fair value measurement disclosures when the recoverable amount is determined based on a fair value measurement, as we believe the "fair value less cost to sell" measurement objective consists of two separate components: fair value and cost to sell. As such, we recommend the IASB consider making a consequential amendment to paragraph 134(e) of IAS 36 to refer to the disclosure requirements in the newly-issued IFRS on fair value measurements and disclosures. Excluding the fair value disclosures when the recoverable amount for an asset equals its "fair value less cost to sell" seems inconsistent with one of the stated objectives of the IASB's Fair Value Measurement project, which is to enhance disclosures about fair value to enable users of financial statements to assess the extent to which fair value is used and to inform them about the inputs used to derive those fair values. The IASB could also clarify that the amounts disclosed would relate only to the fair value of the impaired asset and explanatory language could be included to enable users to better track the disclosures to the amounts recognized in the balance sheet (fair value less cost to sell).

If, however, the IASB believes that the fair value measurement disclosures are not required when the recoverable amount is determined using fair value less costs to sell, this should be made explicitly clear in any finalized standard. We recommend the IASB also consider whether similar issues might emerge with respect to "nonrecurring" measurements in other IFRSs.

Duplicative disclosure requirements
We believe the Boards should assess whether other current disclosures required under US GAAP and IFRS would be deemed redundant or less relevant given the new disclosure requirements in the proposed ASU and ED. Such an assessment would seem to be consistent with the objective of the FASB's Disclosure Framework project.

For example, Topic 860, Transfers and Servicing (ASC 860), requires a specific sensitivity disclosure for retained interests. ASC 860-20-50-4c states that reporting entities should perform a sensitivity analysis or stress test showing the hypothetical effect on the fair value of retained interests of two or more unfavorable variations from the expected levels for each key assumption used in their valuation, considered independently from any change in another key assumption. Given the proposed disclosure requirements on measurement uncertainty analysis, such a requirement seems redundant for residual interests measured at fair value using significant unobservable assumptions. As such, upon the issuance of any final guidance that requires new measurement uncertainty disclosures broadly, we recommend the FASB clarify that the sensitivity disclosures in ASC 860-20-50-4c would not be applicable for Level 3 measurements.

Significant transfers
We note that the proposed ASU amends ASC 820 to require information to be disclosed about all transfers between Level 1 and Level 2 of the fair value hierarchy, not just those that are deemed to be significant. We believe the Basis for Conclusions of the final ASU should explain why the
FASB moved away from requiring disclosures only of significant transfers, given that this requirement was just issued by the FASB in January 2010 (as part of ASU 2010-06).

Question 9

The Board has decided to require limited retrospective transition. Do you think that proposal is appropriate? If not, why not?

We believe the transition guidance in the proposed ASU is appropriate. In our view, reporting a cumulative-effect adjustment to beginning retained earnings in the year the guidance is adopted provides transparency into the effect of the amendments and clarifications to the principles of fair value measurement on the reporting entity. We agree with the FASB’s conclusion that full retrospective transition would be both impracticable and costly.

However, we recommend that the FASB further clarify (in the actual transition guidance) that any changes in fair value related to amendments to ASC 820 that are not linked to the transition guidance of the final ASU (because the FASB believes they are insignificant in nature and would not change practice) would become effective immediately upon the issuance of a finalized standard.

Question 10

There is no link to the transition guidance for the proposed amendments that the Board believes would not change practice. Are there any proposed amendments that are not linked to the transition guidance that you think should be linked? If so, please identify those proposed amendments and why you think they should be linked to the transition guidance.

Overall, we believe the links to the transition guidance have been appropriately identified in the proposed ASU. However, we have noted the following provisions currently not linked to the transition guidance that may benefit from further consideration.

ASC 820-10-30-6: While ASC 820 as currently written is clear that the transaction price does not necessarily equal fair value at initial recognition, it does not explicitly address how to account for any such differences. As ASC 820-10-30-6 clearly states that any difference between the transaction price and fair value should be recognized as a gain or loss in earnings, unless the accounting Topic that requires fair value as the measurement states otherwise, we propose that the FASB consider linking this provision to the transition guidance.

ASC 820-10-50-8: The proposed ASU amends this paragraph to clarify that “a reporting entity shall determine whether users of its financial statements need any other information to evaluate the quantitative information disclosed.” While we do not expect constituents would necessary believe any new information provided would need to be disclosed retrospectively (i.e., as part of comparative disclosures), linking ASC 820-10-50-8 to the transition guidance will make it clear that new information would only need to be disclosed prospectively.
Question 11

The amendments in this proposed Update would apply to public and non-public entities (that is, private companies and not-for-profit organizations). Should any of the proposed amendments be different for non-public entities? If so, please identify those proposed amendments and describe how and why you think they should be different.

We do not believe that the objective of a fair value measurement, or the principles on how this measurement should be determined, should be different for public and non-public entities. Therefore, we support the Boards’ decision that the amendments in this proposed ASU should apply to both public and non-public entities.

Question 12

How much time do you think constituents would need to prepare for and implement the amendments in this proposed Update?

Given the diversity in practice in applying certain aspects of ASC 820, we expect certain reporting entities will need to significantly change their valuation methodologies for certain of the proposed amendments. For example, we believe the clarification that prohibits the use of blockage factors in all fair value measurements will result in a change in practice for many constituents. These entities will need sufficient time to implement such a change, as it would affect the manner in which they gather information for valuation purposes. In addition, determining a liquidity adjustment on an aggregate basis for the entity’s entire position in a particular product will no longer be appropriate. Instead, an assessment of whether a discount is appropriate for lack of marketability or the size of the individual instrument will need to be made at the unit of account level for Level 2 and 3 measurements. This will also take time to address.

We believe preparers also will require significant time to implement the measurement uncertainty disclosures outlined in the proposed ASU. In many instances, these disclosures will require reporting entities to gather and analyze information that has not been previously captured. This will likely require system updates or time-consuming manual work-arounds. As previously noted, additional challenges may be faced by entities that utilize third-party service providers in developing their fair value measurement estimates.

For these reasons, we do not believe an effective date prior to 2012 is operational. However, we would not object to allowing reporting entities to early adopt the amendments. In addition, we support the FASB’s view that any amendments that are not linked to the transition guidance should become effective immediately upon the issuance of the final ASU.
Debt and Equity Valuation Example

Assumptions:

- Enterprise value of Portfolio Company A (controlling basis) = $1,150
- Debt has a par value of $100 and includes a change in control provision
- Fair value of debt (on a stand-alone basis) = $80
- Debt and a controlling equity interest in Portfolio Company A are held in the same investment company

<table>
<thead>
<tr>
<th>Current Practice</th>
<th>Proposed ASU</th>
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<tbody>
<tr>
<td>Accounting value of the debt and equity equals the total controlling enterprise</td>
<td>Accounting value of the debt and equity will not equal the total controlling</td>
</tr>
<tr>
<td>fair value of $1,150.</td>
<td>enterprise fair value of $1,150. ($80 + $920 = $1,000)</td>
</tr>
<tr>
<td>• Debt is recorded at $100 due to change in control provision (sell bonds to</td>
<td>• Debt is recorded at fair value of $80 (price in the secondary market)</td>
</tr>
<tr>
<td>same market participant to whom the equity is sold)</td>
<td>• Noncontrolling equity interest is recorded at $920 (Noncontrolling</td>
</tr>
<tr>
<td>• Controlling equity interest is recorded at $1,050 (Controlling enterprise</td>
<td>enterprise value of $1,100 less $80 fair value of debt)</td>
</tr>
<tr>
<td>value of $1,150 less $100 par value of debt)</td>
<td>• Reduction in total value of $150 from current practice</td>
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