September 17, 2004

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 1201-100

Dear Ms. Bielstein:

Bank of America appreciates the opportunity to comment on the Proposed Statement of Financial Accounting Standards, *Fair Value Measurements* (the ED). We support the development of a conceptual framework to clarify the fair value measurement objective and its application under other pronouncements that require fair value measurements or disclosures. We commend the Board for their efforts in addressing such an extremely important and complicated topic; however, we do not support the final issuance of the ED without significant modifications.

Our comments are organized in our letter as follows:
1. General Comments on the Approach to Fair Value Measurement Guidance
   - “Principles-based” versus “Rules-based” Approach
   - A Comprehensive Concepts Statement versus a FASB Standard
2. Specific Comments on the ED
3. Appendix – Detailed Comments and Responses to Specific Issues

**General Comments on the Approach to Fair Value Measurement Guidance**

The ED adopts a prescriptive “rules-based” approach to fair value measurements as opposed to a “principles-based” framework, which we believe we would better address fair value measurement issues. It appears the prescriptive nature of the ED arises from the Board’s focus on the need to achieve consistency. While we appreciate the importance of consistency, we believe such an approach may result in the inability to apply the necessary and reasonable judgments in order to arrive at a “good faith” estimate of fair value. Therefore, the reliability of fair value measurements may be adversely affected.

We are also concerned that adopting prescriptive rules for purposes of achieving consistency may result in a perceived improvement in the usefulness of fair value measurements that will not actually occur. Fair value measurements are inherently subjective, and therefore an appropriate balance between consistency and reliability is necessary in order to advance their usefulness. The ED does not adequately achieve this balance.
We believe a better approach would be to issue comprehensive fair value measurement principles as an amendment to No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (Concepts Statement No. 7) and to revise and expand the scope of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107) to provide for more transparent disclosures of the entity's fair value measurement techniques, including the effects on reported amounts of variations in significant assumptions underlying the fair value measurements. Such disclosures should be considered in the context of what additional information would be useful to investors and creditors given the existing voluminous financial statement disclosures. We believe this approach would better meet the objective of providing information that is useful to present and potential investors and creditors and would also be a better reflection of existing valuation and market practices rather than attempting to prescribe those practices.

"Principles-Based" versus "Rules-Based" Approach

We are supportive of a principles-based approach to fair value measurements, such as the approach that currently exists in ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies* (ASR 118). While we support a reconsideration of the principles contained in ASR 118, including the need to consider issues not addressed, we believe the ASR 118 approach allows for the exercise of necessary and reasonable judgments in order to arrive at the most representationally faithful fair value estimate.

ASR 118 Section 404.03.b (iv) states, "No single standard for determining 'fair value ... in good faith' can be laid down, since the fair value depends upon the circumstances of each individual case." Although written many years ago, we still believe this statement is true and that a principles-based approach best affords the ability to exercise reasonable and necessary judgments given the individual facts and circumstances that surround each fair value measurement. We believe the ED's prescriptive "rules-based" approach that focuses on consistency without allowing reasonable judgment results in a diminution of the reliability of fair value measurements, and therefore detracts from the fair value measurement objective.

A Comprehensive Concepts Statement versus a FASB Standard

We support the issuance of guidance on the fair value measurement objective as a Concepts Statement (as opposed to a FASB Standard). We believe this is consistent with the objective outlined in the ED, which is to provide a framework for how to measure fair value where other authoritative literature requires fair value as the measurement attribute and to also provide a framework for determining on a project-by-project basis the need for fair value as the relevant measurement attribute in future FASB Standards. We also believe the purpose of the ED is the same as the stated purpose of the Concepts Statements, as noted in the following excerpt from Concepts Statement No. 7:

"Statements in this series are intended to set forth objectives and fundamentals that will be the basis for development of financial accounting and reporting standards. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting — concepts that guide the selection of transactions, events, and circumstances to be accounted for, their recognition and measurement, and the means of summarizing and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting and reporting standards."
Statements of Financial Accounting Concepts do not establish standards prescribing accounting procedures or disclosure practices for particular items or events, which are issued by the Board as Statements of Financial Accounting Standards. Rather, Statements in this series describe concepts and relations that will underlie future financial accounting standards and practices and in due course serve as the basis for evaluating existing standards and practices.

We recognize that the ED was probably issued as FASB Standard in order to be higher level GAAP and because of the new proposed disclosure requirements. However, these objectives can still be achieved if issued as a Concepts Statement by including the new disclosures as an amendment to FAS 107 and by referencing in other FASB Standards to the fair value concepts similar to how Concepts Statement No. 7 has been referenced in recently issued FASB Standards. In addition, as discussed in our specific comments below, we believe that the Board should address the more significant unresolved fair value issues and issue a comprehensive Concepts Statement related to fair value measurements.

**Specific Comments on the ED**

- **Scope**
  
  Paragraphs C10 – C13 discuss the Board's long-term commitment to requiring all financial instruments to be recorded at fair value and the near-term objective of developing a fair value measurement framework to be used in making future decisions, on a project-by-project basis, as to the relevant measurement attribute. We also note that the Board has several other projects on its agenda that may allow an entity to choose whether to apply fair value accounting to certain financial and nonfinancial instruments.

  We believe the guidance in the ED falls short of providing the comprehensive fair value measurement framework that is a necessary prerequisite for ultimately reporting all financial instruments at fair value and for making interim decisions concerning what financial and nonfinancial instruments are required, or may be elected by the entity, to be reported at fair value. Significant issues that we believe need to be addressed in order to have a useful and comprehensive fair value measurement framework that will effectively underpin future FASB decisions include the following:

  - **The broad and consistent application of the fair value measurement objective.** One would expect that the fair value measurement objective would be applied broadly to all assets, liabilities, and equity recorded, disclosed, or affected by a fair value measurement, including share-based payment, leasing transactions, software and other revenue recognition, loan accounting, and inventories, which were excluded from the scope of the ED. We believe that significant inconsistencies currently exist between the guidance in the ED and the guidance in other pronouncements scoped out of the ED, for example, the fair value approach to share-based payments.

  - **Unit of account issues.** The Board acknowledges in paragraph C28 that the unit of account is inextricably linked to and has a significant effect on fair value, but yet didn’t address unit of account issues in the ED. We believe additional attributes and parameters addressing the appropriate unit of account should be provided, including when it is appropriate to consider blockage factors and control premiums.

  - **Day “two” accounting for certain instruments.** We believe the ED should fully address both initial recognition and subsequent accounting at fair value. As drafted, the ED does not adequately deal with the dilemma that currently exists when a contemporaneous estimate of fair value differs from the actual transaction price.
While the ED may appear to address the initial (or “day one”) accounting, it does not appropriately deal with the subsequent (or “day two”) accounting for certain instruments, for example, financial instruments and other derivatives subsequently valued using internally developed techniques. We believe this is a fatal flaw in defining the fair value measurement objective.

We believe the lack of a comprehensive framework coupled with the Board’s presumption that fair value is the most relevant measurement attribute has resulted in the current mixed-attribute accounting model that often results in asymmetrical accounting that does not reflect the underlying economics. Not addressing all of the significant fair value measurement issues results in an inadequate framework for making future decisions that will improve and eliminate issues with the existing mixed-attribute model. We believe the additional time that will be necessary to fully develop the framework is well worth the delay in issuing final guidance.

- **Present Value Techniques Using Cash Flows (in Appendix A)**
  The guidance on the three different present value techniques is extremely confusing with regards to the inclusion of risk and uncertainty and is not reflective of market practices.

- **Valuation Premise**
  The guidance on the use of entity-level versus marketplace assumptions does not appear entirely consistent throughout the ED and if applied literally will not always properly reflect the value of an asset or liability.

- **Fair Value Hierarchy**
  The three-tiered fair value hierarchy needs clarification in order to be a consistent and workable model in practice. In the absence of further guidance and more realistic examples, the Level 2 estimates should be eliminated and subsumed into Level 3(a). In addition, we do not support the requirement to always use more than one valuation technique for Level 3 measurements.

- **Reference Market**
  The Level 1 reference market should be the market where the asset is principally traded (i.e., the deepest and broadest market) as opposed to the “most advantageous market.” The use of the “most advantageous market” provides for anomalous and inconsistent results and is not consistent with the definition of fair value and guidance provided elsewhere in the ED. We also believe that if transaction costs are considered in determining fair value, they should be included in the fair value measurement.

- **Use of Bid-Asked Prices**
  We strongly disagree with the requirements to use bid prices for long positions and asked prices for short positions. We believe the mid-market price, adjusted for relevant credit and liquidity discounts, is a better reflection of the fair value objective, more consistent with existing market practices, and more reflective of where trades actually occur.

- **Blockage Factors and Control Premiums**
  We believe that prohibiting blockage factors and control premiums in fair value estimates is inconsistent with the definition of fair value and existing market-based valuations.
Disclosures

We believe the proposed disclosures merely add to a current overload of financial statement disclosures and may not best represent information that is most useful to investors and creditors. We also believe the proposed disclosures should be reconciled and consolidated with the fair value disclosures in FAS 107.

Once again, we appreciate the opportunity to comment. If you have any questions regarding our comments, please feel free to contact us.

Sincerely,

/s/ Randy Shearer

Randy J. Shearer
Director of Accounting Policy

cc: Mr. Marc D. Oken
    Chief Financial Officer

    Mr. Neil Cotty
    Chief Accounting Officer
Appendix – Detailed Comments and Responses to Specific Issues

Introduction
As noted in our letter, we believe fair value measurement guidance should be issued in the form of a Concepts Statement that establishes a comprehensive principles-based framework for fair value measurements. In this appendix, we have provided our detailed comments to the Issues outlined in the ED based on the premise that the ED is issued as a FASB Standard.

Issue 1: Definition of Fair Value

General
Paragraph 4 defines fair value as “the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.” The objective of the measurement is to estimate the price for an asset or liability in the absence of an actual exchange transaction for that asset or liability. We agree conceptually with this notion of fair value, which is essentially the same as the existing literature; however, we believe certain clarifications and changes are necessary.

Actual Transactions
The ED assumes (see paragraphs 5, B3, and C24) that the price paid in an actual exchange between unrelated willing parties always represents fair value. This is based on the presumption that markets, and market participants, are always rational and consistent. We believe this is a significant presumption and we do not always agree with it. In fact, we believe the entire ED is written based on a perception that market participants are always rational, always interpret data consistently, and always act in a consistent manner, which is not always the case. While we suggest retaining the basic fair value objective, we believe that it should be clarified by expressly stating that there is a rebuttable presumption that the exchange price is always fair value with additional principles on when this presumption may be overcome.

Our main concern is that the assumption that a market transaction always represents fair value is built off another significant presumption in paragraph 5, which states that “Willing parties are presumed to be market participants representing unrelated buyers and sellers that are (a) knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction, and (b) willing and able to transact in the same market(s), having the legal and financial ability to do so.” Applied correctly, this presumption works from a conceptual perspective because it would eliminate all irrational market transactions from the spectrum of transactions to be considered in determining fair value. But from a practical standpoint, a sufficient basis is necessary to support the presumption that market participants are always knowledgeable and rational, with the ability for facts and circumstances to dictate otherwise. We believe this is necessary because the reality is that market participants may not always act in a rational and consistent manner or they may be driven by motivational factors that are unique to them.

For example, market activity in exchange-traded instruments (e.g., an actively traded NYSE stock) meets the presumption because the volume of activity averages out inconsistent market transactions. However, the same conclusion may not necessarily be extended to a single trade; it is the reference to the entire market that accumulates hundreds of thousands of inputs...
(most of which are rational and consistent, but some of which are not) that defines fair value and meets the criteria in paragraph 5.

When extending that same notion to, for example, unique non-exchange traded contracts, more judgment and consideration is necessary to arrive at the proper conclusion. Without consideration of the particular facts and circumstances (i.e., knowledge of the counterparty, terms of the trade, etc.) it is not always appropriate to presume that a trade is executed at a value which would be considered fair value for both counterparties. Individual market participants may not always act in a consistent manner, or the volume of transaction activity for one side of the exchange may result in a day one initial unrealized profit or loss for one of the counterparties even though the other counterparty may reasonably conclude that the exchange was at fair value. In other words, there are non-exchange trades that are not executed at the same fair value amount for both counterparties. We believe this omission is a significant flaw in the basic presumption outlined in paragraph 5, especially from a practical standpoint because we believe market participants do not always act in a consistent manner.

It is for these reasons that we urge the Board to provide a clear statement in the body of the Standard that there is a rebuttable presumption that fair value is the price paid in an actual exchange transaction and then define the factors to consider in overcoming such presumption for those situations where the consideration paid is not representative of what is deemed to be fair value for one or both of the counterparties. For example, principles could be outlined such as when one of the counterparties benefits from synergies and efficiencies, when one of the counterparties is motivated by unrealized potential benefits that do not benefit the other counterparty, when a side agreement or multiple elements exist in a transaction (including intangibles or implicit elements), or when one of the counterparties does not have a complete and common understanding of relevant information.

We believe that providing additional guidance on when the transaction price does not reflect a contemporaneous estimate of fair value is necessary in order to reconcile with the day “two” accounting issues. To address these issues, the Board should establish principles related to measuring a transaction shortly after (or at) consummation at an amount different than the transaction price, which we think may be appropriate in certain circumstances.

Hypothetical Transactions
The second sentence of paragraph 5 states that “Thus, the estimate [of fair value] is determined by reference to a current hypothetical transaction between willing parties.” It is unclear how this sentence relates to the situation where the actual transaction was not representative of fair value. We believe this means that given appropriate facts and circumstances, an entity may determine the hypothetical transaction based on a transaction with a truly willing and knowledgeable counterparty, and consider that difference in subsequently measuring the transaction. If so, this is consistent with our comments above on actual transactions.

In addition, we are concerned with how the phrase “hypothetical transaction” relates to the Board’s views on developing fair value measurements for financial and nonfinancial instruments in the absence of a readily available and active market. We believe the Board should clarify the inputs and assumptions that can be hypothesized, including a clear statement that the hypothesis relates to the inputs used in valuing an asset or liability that is measured at fair value, and not the hypothesis of variables that may impact whether or not the
asset or liability should be recorded at fair value, for example, hypothesizing as to the existence of a market that does not exist. We also note that while we generally agree that market inputs should be used in determining the hypothetical amount, we also believe that it should be permissible to incorporate entity-specific benefits in certain circumstances (e.g., tax benefits or other entity-specific benefits based on the expected use of an asset that might also be available to other entities with similar facts and circumstances, but may not be available to all entities).

To summarize, we generally agree with notion of “hypothetical transaction” from a conceptual perspective, but we believe additional guidance and clarity is necessary to avoid misunderstandings, inconsistencies, and even potential abuses in practice. Such additional guidance and clarity may also be useful in the further development of an overall framework to be used in deciding what types of instruments should be recorded at fair value.

**Consistency**

We refer you to the body of our letter where we comment on the prescriptive nature of the ED and our preference for principles over prescriptive rules. We also note that while certain aspects of the ED may be interpreted and applied consistently within an entity, the ED may still result in an inconsistent understanding and application of the fair value definition among different entities. We recognize balancing rules for consistency and principles is not an easy task, but we believe addressing some of the issues we raise elsewhere in our letter may serve to reduce the potential for misunderstanding and inconsistency.

**Scope Exceptions**

We do not agree with the statement in paragraph 1 that the ED applies broadly to financial and non-financial assets and liabilities that are measured at fair value given the scope exceptions in paragraph 2. We also believe the sentence in paragraph 1 should be clarified to state whether it applies to only fair value measurements for recognition purposes or whether it also applies to fair value measurements for disclosure purposes.

Since the objective of the ED is to outline a single fair value measurement objective, the final fair value measurement guidance should apply broadly to all fair value measurements, including the paragraph 2 scope exceptions related to share-based payment, leasing transactions, software and other multiple element revenue recognition, loan accounting, and inventories. For example, we cannot understand the rationale behind the fair value conclusions for share-based payment in the Proposed Statement of Financial Accounting Standards, *Share-Based Payment* and the proposed fair value measurement guidance in this ED. In particular, it is unclear why a restriction discount is specifically permitted for restricted securities in paragraphs B17 – B19 and yet proscribed in the share-based payment ED for employee stock options. Given the lack of liquidity and transfer restrictions related to employee stock options, we believe the approach to employee stock options should be the same as the approach to restricted shares.

We recognize that certain of the measurement principles in the existing literature related to the scope exception areas mentioned above did not intend to specify fair value as the measurement objective. However, we also recognize that at least some of the measurement principles for all of those scope exceptions did intend for the measurement objective to be
Therefore, we suggest that the Board review the existing literature related to those scope exception areas and identify the relevant measurement objectives. Once this has been completed, the existing literature should be amended to specifically clarify whether the measurement objective is or is not fair value. For those measurement principles intended to reflect fair value, the general guidance in the final fair value measurement pronouncement should apply. For those measurement principles not intended to reflect fair value, the amendments to the existing literature should clearly state that fair value is not the measurement objective and then explain the intended measurement objective. An appendix similar to Appendix E could be created and maintained to describe all other authoritative pronouncements where certain measurements are not intended to be fair value.

We also suggest the Board delay issuance of final fair value guidance until the Board addresses the issues in other existing projects (see paragraph C14) that could reasonably result in a subsequent amendment to the fair value guidance.

Issue 2: Valuation Techniques (Appendix A)

General

We support the inclusion of guidance in Appendix A on the use of cash flows in present value techniques and we agree with the decision in paragraph C41 that any present value technique that does not appropriately include an adjustment for risk will not produce a measurement that faithfully represents fair value. We also agree with expanding the existing guidance in Concepts Statement No. 7 to clarify that when using expected cash flows the adjustment for systematic and nondiversifiable risk may be reflected in the discount rate since current valuation practices rarely include all of the risk premium in the cash flows.

Despite the incorporation of guidance on the use of present value cash flow techniques in the ED and the intended clarifications to Concepts Statement No. 7, we believe confusion still exists, and has perhaps been exacerbated, regarding how to appropriately include risk and uncertainty under the three different present value techniques. In particular, there is a lack of clear and sufficient guidance regarding the relationship between risk and uncertainty (systematic, nondiversifiable, and entity-specific) and the use of appropriate discount rates, cash flow sets, and/or probability weightings under the three present value techniques. This confusion arises, in part, from the fact that the risk and uncertainty premium explained in items (b) and (c) of paragraph A2 is incorporated differently depending on which of the three present value techniques is used, but the guidance inadequately explains and illustrates the rationale for these differences.

Three Alternative Present Value Techniques Using Cash Flows

Our understanding is that present value techniques using cash flows should capture the elements of amount, timing, and uncertainty. The incorporation of risk is necessary in order to recognize the uncertainty element (i.e., that in most cases cash flows are estimates rather than known events). We agree with these general principles, which are consistent with the six necessary elements when using a present value technique as described in paragraph A2.

For example, lease accounting literature refers to the fair value of the leased property and the use of fair values for leases involving both land and buildings.
However, the manner in which the ED discusses the differences in how the six elements (in particular risk and uncertainty) are included in each of these three techniques is confusing, too theoretical, and not aligned with market perceptions and how valuations are performed in practice. The determination of risk and uncertainty is very subjective; however, the ED implies an artificial level of precision that can be obtained by reconciling among the three different approaches. We believe this attempts to create a practice, which does not and cannot occur. We also believe the market generally will use different valuation techniques based on varying assumptions and come up with a range of different valuations (that do not reconcile exactly to one another), and consider the range in determining the best estimate of fair value. In fact, if the different techniques did reconcile then we are unsure of the need for but one of the three models.

As described in the ED, risk or uncertainty may be captured (at least to some degree) by the use of probability-weighted cash flows, by the cash flow sets themselves, or by inclusion of risk into the discount rate. The table below summarizes how risk and uncertainty is included in the three techniques.

<table>
<thead>
<tr>
<th>Technique</th>
<th>Ways to Include Risk/ Uncertainty</th>
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<tbody>
<tr>
<td>1. Discount Rate Adjustment</td>
<td><strong>Sets of Cash Flows</strong></td>
</tr>
<tr>
<td>2. Expected Present Value - Risk-Adjusted Discount Rate</td>
<td>X - some aspect of risk in the rate</td>
</tr>
<tr>
<td>3. Expected Present Value - Risk-Free Discount Rate</td>
<td>X - cash flows adjusted for risk</td>
</tr>
</tbody>
</table>

Although the ED generally presumes that the fair value result will be the same regardless of which of the three techniques is used, as stated above, we believe this will not be the case absent an entity proving it by using all three methods, which will not occur in practice. Therefore, additional clarity is needed to resolve the confusion that exists between these three techniques; in particular, to resolve confusion surrounding the relationship between the approaches to estimated cash flows (especially when using probability-weighted cash flows) and the use of the appropriate discount rate.

Our main concern lies in the confusion regarding the choice of an appropriate discount rate that adequately reflects only the risk and uncertainty not otherwise factored into the present value technique via the approach to estimated cash flows. Although the appropriate discount rate differs for each of the three techniques, there is not adequate and clear guidance on how to determine these differences. This is especially concerning when an entity uses a probability-weighted cash flow approach, since uncertainty has to always be factored in at least to some extent by the mere probability-weighting of the cash flows. The last sentence of paragraph A13 (reproduced below) highlights this issue by implicitly stating that when the discount rate incorporates risk and uncertainty, the extent to which such risk and uncertainty

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2 We believe that the mere probability weighting of cash flows has to factor in at least some aspect of uncertainty although it is not clear in the ED how much.

3 That is, without omitting or double-counting risk and uncertainty.

4 We also draw your attention to FASB Statement No. 143, Accounting for Asset Retirement Obligations (FAS 143), which further confuses the issue by discussing the use of a "credit-adjusted risk-free rate", essentially another derivation of the above techniques.
is included in the discount rate will vary depending on whether the cash flows used are a best estimate or a probability-weighted set of cash flows.

"To the extent the cash flows used in those techniques are different, the risk-adjusted discount rates also will be different because the risks in the cash flows differ; however, the estimated fair values will be the same."

This means that if you use technique #1 (the "discount rate adjustment technique"), the discount rate is higher than if you use technique #2 (the "expected present value - risk-adjusted discount rate technique") because the probability weighting of cash flows captures at least some aspect of risk and uncertainty, albeit the ED does not provide sufficient guidance on how to measure this difference. In other words, under technique #1 all of items (b) through (f) of paragraph A2 are included in the discount rate, whereas under technique #2 items (b) through (f) are dispersed among the discount rate and the probability weighting of cash flows. While this may be conceptually sound, without additional clarity the objective of achieving similar results under these two different techniques will not be accomplished because risk will either not be appropriately included or it will be double counted.

To further confuse the issue, there is alternative #3 (the "expected present value - risk-free discount rate technique") where presumably a risk-free discount rate is appropriate because all the risk and uncertainty is included in the cash flow set, which is also probability-weighted. We do not understand the basis for this approach. First, if we were to truly use cash flows that market participants would use, then they would presumably include the risk premium in the cash flows and there would be no need to probability weight various scenarios. Second, we cannot seem to locate any real examples of where the entire risk premium is included in the cash flows sets that are then probability-weighted and discounted using the risk-free rate, which is probably because this method is not used or accepted in practice. Third, we do not understand how you can incorporate risk in the cash flows and probability-weight those same cash flows since both the risk inclusion and probability weighting seem to some extent be intended to accomplish the same objective of incorporating risk and uncertainty. This technique implies that risk and uncertainty are mutually exclusive, for which we disagree. We also question whether this technique does not almost always result in double-counting or compounding risk and uncertainty to some degree. We believe further clarity is needed to appropriately distinguish this technique from the other two techniques and to ensure elements of risk and uncertainty are appropriately considered.

Selection of the Discount Rate - Additional Specific Comments

We notice that paragraph A10 briefly discusses the derivation of the risk adjustment to be included in the discount rate when using the discount rate adjustment technique. As stated above, we believe additional guidance on the selection of the appropriate discount rate under each of the three present value techniques should be developed and given more prominence, especially since the discount rate is often the most significant assumption.

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5 Other than, of course, the ED's presumption that you would be able to reconcile the two alternatives exactly to one another to arrive at a single fair value estimate.

6 We also note as a detailed comment, that the first sentence of paragraph A12 (by its reference to having the same set of cash flows for either approach) does not appear consistent with allowing the risk premium to be included in the discount rate when using the expected present value technique. We believe that the reference in the parenthesis of the second sentence "(not otherwise reflected in the cash flows)" was intended to resolve this inconsistency, but this is both unclear and confusing, and only adds to the misunderstanding regarding the relationship of probability factors and risk adjustments in the discount rate.
We recommend that such additional guidance include a comprehensive explanation of the principles to consider in determining the appropriate discount rate giving consideration to the elements in paragraph A2 and the differences that may arise depending on the present value technique employed. The focus should be on selecting a discount rate that factors in only the residual risk and uncertainty not otherwise accounted for by way of the approach to cash flows. We refer you to the factors in paragraph A10, the guidance in paragraph 13 of APB Opinion No. 21, *Interest on Receivables and Payables* (APB 21), and the existing principles established in Concepts Statement No. 7, which may be helpful in establishing principles. We also specifically note that we believe the tax consequences to the buyer and the seller may be a factor in determining the discount rate (for example, the fair value of a taxable and nontaxable asset would likely differ).

### Use of Probabilities in Present Value Techniques – Additional Specific Comments

While we understand the conceptual merit of using probability-weighted cash flows in present value techniques when the risk and uncertainty can be appropriately captured and not double-counted, we believe a principle should be stated that such probabilities are only incorporated in present value techniques to the extent they are sufficiently objective, which we believe would be a fairly limited occurrence.

Many of the examples given in the current and proposed literature are overly simplistic, when in reality, the use of probabilities in present value techniques is very difficult due to the extreme subjectivity of assigning probabilities to possible outcomes. We also note that Concepts Statement No. 7 paragraph 62 provides guidance on how and when to incorporate risk and uncertainty into present value techniques stating "... an arbitrary adjustment for risk, or one that cannot be evaluated by comparison to marketplace information, introduces an unjustified bias into the measurement." We believe similar guidance is needed on the use of a probability-weighted cash flows approach, including principles relating to the determination of possible outcomes, how many possible outcomes should be considered in different scenarios, and the related assignment of probabilities to the possible outcomes. A fundamental principle should be established that the traditional best estimate approach better reflects the present value measurement objective than an arbitrary incorporation of probability assessment, and therefore, the probability-weighted cash flows approach is used only when the assignment of probabilities to potential outcomes is objectively determinable.

### Incorporating Credit Standing in the Valuation of Liabilities – Additional Specific Comments

While there may be some rationale in incorporating an entity's credit standing in measuring its trading liabilities, we generally disagree with the inclusion of an adjustment to reflect an entity's credit standing in measuring the fair value of an entity's own liabilities. This is based on our belief that the adjustment for credit standing is never ultimately realized because there is always an offsetting detriment to any perceived benefit. It also seems counterintuitive to the underlying economics.

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7 Paragraph 13 of APB 21 included reference to tax benefits in determining the interest rate, although that guidance is proposed to be deleted as shown in Appendix D of the ED.

8 For example, the number of outcomes might vary in proportion to the volatility of the item being valued. Alternatively, volatility might also be a factor to consider in the discount rate if probabilities are not used.
For example, if an entity reduced the fair value of its long-term debt as a result of a decline in creditworthiness, even if it settled the debt at the reduced amount, it would incur additional costs in obtaining replacement debt (the offset being in the interest rate). The same notion can be extended to situations where an entity reduces the amount of a trading liability as a result of a decline in creditworthiness. Even if the entity settled the trading liability for a perceived benefit, the entity would be detrimentally affected by the change in credit standing in the subsequent transaction the entity enters into.

If, despite our comments, the Board retains the current notion as articulated in the ED, we suggest providing additional guidance on including credit standing in the cash flows or discount rate. Appendix A states that credit standing is ordinarily included in the discount rate, but we are unclear as to how this relates to situations where the cash flows are based on marketplace assumptions that already reflect the credit adjustment.

**Summary of Comments on Three Present Value Techniques**

We agree conceptually that a valid present value technique should capture the six necessary elements in paragraph A2; however, we believe the current discussion in Appendix A does not provide an adequate basis for explaining how to capture the six elements, but rather is confusing, too theoretical, and not principles based. We believe the Board should reconsider the guidance on cash flow techniques as follows:

- Focus on the principles and objectives and allow the use of any technique that meets the principles and objectives.
- Focus the discussion of the types of present value techniques on valuation techniques that are used in practice. Where necessary, perform market studies to ascertain which techniques are used in practice, and do not discuss a technique that is not used.
- Provide more guidance on the selection of the discount rate.
- Provide more discussion on the development of ranges of values based on different techniques and how to consider the best point within the range, as opposed to the "exact" reconciliation of different techniques, which will not happen in practice.

Regardless of how many different techniques are ultimately retained, we believe crisp and clear principles (along with relevant and realistic examples) that provide adequate guidance on how to incorporate the six elements in paragraph A2 under each present value technique and also explains the rationale and differentiation among the techniques is critical to appropriately applying the techniques in practice. Unfortunately, Appendix A currently focuses too much on the objective of achieving the same result under each present value technique, which will rarely be verifiable or achievable in practice (otherwise there would be little need for more than one technique) as opposed to an objective of determining the best estimate of fair value, which is often based on consideration of ranges of values.

**Issue 3: Active Markets**

We have no specific comments on additional guidance necessary for purposes of defining active markets. However, we do have related comments with respect to the use of entity versus market inputs (Issue 4) and on pricing in active dealer markets (see Issue 7).
Issue 4: Valuation Premise

General Comments
We generally agree with the notion that the valuation should give consideration to the condition, location, and expected use, although we believe a distinction exists in the application of these principles to financial and nonfinancial instruments. In addition, we are concerned about the relationship between the valuation premise and the general principle to use market assumptions as opposed to entity-specific assumptions.

Nonfinancial Instruments
We believe a distinction should be drawn between financial and nonfinancial instruments in applying the condition, location, and expected use elements. For purposes of valuing nonfinancial instruments, we believe that the valuation premise should always consider the condition, location, and the entity's expected use. For example, if an entity acquires real property to use in its operations, the valuation should not be based on the rental value of such property (even if some market participants may consider such in their valuations), but should be based on the entity's expected use of the property in order to achieve appropriate matching of revenues and expenses. The marketplace's intended use or settlement of a nonfinancial instrument is irrelevant once the entity makes a decision as to its actual use or settlement. In addition, the assumptions used in valuing nonfinancial instruments are often necessarily based on the entity's assessment of condition, location, and use since the views of market participants are often difficult to obtain, or because there is no market consensus.

Financial Instruments
For purposes of valuing financial instruments, the condition, location, and expected use elements may not always be relevant. For active exchange-traded financial instruments that do not give rise to counterparty specific credit or liquidity risk, the valuation should be based on the value in the principal and most active exchange market (i.e., the deepest and broadest market), irrespective of the condition, location, and expected use. However, for purposes of valuing financial instruments that are not actively traded (or that otherwise give rise to specific credit or liquidity risks), we believe the general principle should be to consider marketplace assumptions, but that where necessary, entity-specific assumptions, including those specific to some but not all market participants (and that are not obviously inconsistent with what similar market participants would assume), may be considered. For example, entity-specific assumptions may be necessary when the financial instrument is not based on an identical exchange traded instrument or when the instrument gives rise to entity-specific benefits that may be available to some, but not all market participants.

Marketplace vs. Entity-Specific Assumptions
We believe that certain portions of the ED mix the concepts of marketplace and entity-specific assumptions. Therefore, as mentioned above, we believe that instead of a broad principle of using marketplace assumptions in all fair value estimates, there should be different principles established for financial and nonfinancial instruments. Instances in the ED where we believe there is confusion between marketplace and entity assumptions include:

9 We make reference, for example, to paragraph A7 of FAS 144 in Appendix D where the ED actually proposes a change to clearly refer to entity-specific assumptions in valuing long-lived assets.

10 We recognize that a change in intent could result in a change in the manner by which an asset or liability is valued. In such circumstances, we believe existing GAAP adequately addresses whether an asset or liability is subsequently remeasured at fair value.
- **Paragraph 5** – The last sentence of paragraph 5 states, "In all cases, that price shall be estimated without regard to an entity’s intent to currently enter into such transaction." We believe this conflicts with other aspects of the ED, such as paragraphs 13 and 16.

- **Level 1 Reference Market in paragraph 16** – By requiring consideration of the “most advantageous market” and the entity’s cost to transact, the ED results in an entity-specific approach for quoted prices, which seems to conflict with the general principle of marketplace assumptions and the definition of fair value itself.

- **Level 1 Reference Market in paragraph 17** – The prescriptive guidance on bid-asked prices for certain assets and liabilities seems to infer a distinction in value based on the intent with respect to holding an asset or liability and introduce asymmetry in the value for the same asset or liability depending on whether the entity valuing the asset or liability is long or short. We believe this is inconsistent with the definition of fair value.

- **Example 1 in paragraph B3** – It is unclear as to whether this example is intended to state that the valuation is based on the entity’s expected use of the acquiree or the markets perception. We believe this example illustrates that the purchase price is the fair value even though that purchase price is based on the buyer’s assumptions, which is not entirely consistent with what other market participants may be willing to pay. If so, this results in an inconsistency with the broad guidance on using marketplace assumptions when they may differ from the entity’s expected use of the property. We believe in the example, the valuation should be based on the entity’s expected use of the property, which is consistent with our recommendation on a distinction in the valuation premise for financial and nonfinancial instruments.

- **Example 2 in paragraph B5** – This example seems to be the use of entity-specific assumptions despite the reference being to marketplace assumptions.

- **Example 3 in paragraph B7** – The guidance seems to indicate that the valuation of equipment should be based on the entity’s expected use of it. While we agree with this, it seems to conflict with the general principle in the last sentence of paragraph 13. In addition, we are unsure of whether the second sentence of item (b) is intended to state that the entity and market participants would always agree on the use of the property (in this case, selling it). If that is the implication, we disagree with it. However, if the sentence were intended to mean that if the entity chooses to sell the property, they should consider assumptions that market participants would likewise consider if they were selling the property, then we agree. In either case, the sentence should be clarified.

- **Example 6 in paragraph B11** – This example implies that different market participants would assign different values depending on the expected use of the property and that the valuer decides to use a valuation based on their intended use of the property. While we agree with this notion, we are not sure of how it relates to last sentence in paragraph 13, or for that matter, the appropriate course of action when there are multiple market inputs that differ depending on the use of the property. Whether the valuer chooses to value the property based on the most predominant marketplace intended use, even if it conflicts with the entity’s intended use, is unclear. We also note, as an unrelated point, that we are unclear as to the intended relationship among the choice of the midpoint of a range and the guidance in FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss paragraph 3, which states “When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued.” We believe this may create an inconsistency, especially between this implication and the guidance on bid-asked measurements.
- **Example 7 in paragraphs B13-B14** – This example seems to imply that the fair value estimate is based on the entity’s assumptions as opposed to marketplace assumptions.

- **Costs to Sell in paragraph C26** – We believe that where other GAAP, such as FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* requires that fair value be reduced by estimated costs to sell, the valuation should similarly reflect the entity’s expected disposal of the asset. Therefore, we encourage the Board to make it clear in paragraph C26 that if an asset is held for sale and other GAAP requires the valuation to be reduced by costs to sell, the valuation should consider the entity’s expected approach to disposal to avoid a deferral of unrealized losses.

- **Software Revenue Recognition Scope Exceptions** – A perceived inconsistency exists between market and entity information by excluding from the scope of the ED the current guidance on software revenue recognition.

- **Day “Two” Accounting Scope Exception** – By excluding from the scope the “day two” accounting, the ED does not adequately address the use of entity-specific estimation models that differ from the initial transaction price. We are therefore unsure of the impact the ED has on proprietary valuation models used to value certain non-exchange traded contracts for which each individual instrument has unique features with respect to one or more aspects, including credit and liquidity risk. For example, it isn’t clear whether the use of an internally developed yield or forward rate curve, which is not inconsistent with market implied assumptions, but that may differ from another entity’s internally developed models, is prohibited. We believe paragraph 24 should be revised to clearly acknowledge the appropriateness of using internal models and related assumptions that are based on market inputs, albeit that may be different from other entities, as either a practical expedient or when necessary for unique, customer-specific contracts. Otherwise, it could be implied that the entity with the largest market share “makes” the market and therefore other entities should apply their model, which would not be possible since it is proprietary. While we agree conceptually with the use of market assumptions in fair value techniques, we do not believe there will always be a consensus as referred to in paragraph C59. As discussed above, this issue could be resolved with a distinction between financial and nonfinancial instruments.

- **Tax Implications** – Many entities enter into transactions to achieve, at least to some extent, a positive tax benefit. We do not believe this should be ignored in determining the fair value of the transaction, especially for nonfinancial assets and liabilities.

In summary, we feel that the model for use of marketplace versus entity-specific assumptions should be further developed with a distinction made in the principles regarding how the valuation premise is applied to financial versus nonfinancial instruments. In doing so, we suggest that in valuing financial instruments, the Board consider the impact on the valuation of financial instruments for which there are no active exchange markets.

### Issue 5: Fair Value Hierarchy

**General**

From a conceptual perspective, we generally agree with a fair value hierarchy. We also believe that the fair value hierarchy established in the ED is generally consistent with existing GAAP. However, we believe several practice issues should be addressed so entities do not spend more time trying to ascertain what level they are in, as opposed to trying to arrive at the best estimate of fair value. This would specifically include the elimination of Level 2
because we do not see a practical distinction with it and Level 3(a). We also believe that certain principles related to one level should apply to the other levels as well, although any such broad-based requirements should be based on principles as opposed to prescriptive requirements that may result in a hindrance to arriving at the best estimate of fair value.

**Level 1 Specific Comments**

1. The Level 1 reference market does not sufficiently factor in liquidity and credit risk for non-exchange traded contracts. See additional comments under Issue 7 below.
2. The reference to “all” in paragraph 7 should be deleted since it would be irrelevant to consider Level 3 valuation techniques when using a Level 1 quoted price. The Board even acknowledges this is in paragraph C59.
3. The general principles established with respect to matters such as the market to use when the entity has multiple access markets, the valuation premise, blockage discounts, and bid-asked prices should apply equally to all three levels in the hierarchy.
4. We have several comments regarding significant events after the close of trading.
   a. We agree with paragraph 18 that the entity’s decision to apply a price other than the closing market price is an accounting policy decision as it allows sufficient flexibility to achieve the objective of fair value. However, we recommend an entity should consistently apply their policy for situations with “similar facts and circumstances.”
   b. We believe additional clarity is necessary regarding how significant events pervade to the valuation of other instruments. For example, significant after-hours price fluctuations in a publicly traded stock may also affect the value of a public bond of the same issuer. Likewise, a transaction in the credit default swap market may be indicative of a change in valuation of the security underlying the credit default swap or similar securities. Therefore, we suggest providing a general statement that the entity’s policy should give adequate consideration to how significant events after the close of trading might also impact the valuation of related instruments.
   c. Notwithstanding our suggestion in 4(b), we believe a “cutoff” as to market closing prices exists. For example, the cutoff could differ depending on the market selected for an individual security as well as different closing prices for different types of securities of the same issuer (i.e., the close of the futures markets, bond markets, and stock markets may differ and is exacerbated by the “most advantageous market” principle). We suggest the Board address this problem. We recommend that, to the extent practicable, all values be taken as of a common snapshot point in time.
   d. We recommend guidance be added that in determining the impact of significant events, the entity consider the volume and depth of activity, among other factors, in determining whether the subsequent event should result in an adjustment to the last quoted price or an adjustment to related instruments.
   e. We also suggest that the guidance apply broadly to all three levels of fair value.

**Level 2 Specific Comments**

1. As indicated in the Level 1 comments, the word “all” in paragraph 7 should be deleted.
2. Based on the limiting nature of Level 2 estimates (i.e., to situations where there is objectively determinable criteria for which different entities would apply the same price adjustment, as mentioned in paragraph C55), it is unclear of when, if ever, a valuation would fall into Level 2. Therefore, absent the requirement to perform more than one valuation technique when in Level 3 (for which we disagree with as stated below), we do not understand the rationale for distinguishing between Level 2 and Level 3(a). We believe, therefore, that Level 2 should be eliminated.
3. If Level 2 is retained, we suggest more meaningful and realistic examples illustrating the application of the objectively determinable criteria be provided in order to distinguish Level 2 and Level 3(a). The example in paragraph 20 is not very helpful. If examples cannot be given, then this further suggests the need to eliminate Level 2.

4. If Level 2 is retained, we believe that the reference in example 4(b) of paragraph B8 should be to "key attributes" as opposed to "not all relevant attributes" since this could give rise to varying interpretations of what "not all relevant attributes" means and could be viewed as inconsistent with the limiting nature of the category as set out by the Board. If additional guidance is necessary on key attributes, ASR 118 may be helpful.

**Level 3 Specific Comments**

1. We strongly believe the ED should clarify that multiple valuation techniques are not always required for Level 3 estimates. We believe this is consistent with the Board's rationale in paragraph C58 to select the valuation technique that best approximates fair value. Instead of requiring multiple valuation techniques, principles should be outlined for determining if more than one valuation technique is necessary. For example, in the context of an entity's recurring valuation of financial instruments using reliable internal models, we see no value added in using more than one valuation technique. However, we would agree that in the context of an entity's valuation of a significant nonrecurring nonfinancial item, for example, valuations in a business combination, multiple valuation techniques might be useful. In this regard, we are supportive of a different model for financial instruments and nonfinancial instruments, or perhaps a different model between recurring and nonrecurring items, which could vary by industry.

2. Paragraph 7(c) should be clarified to state that the cost method applies only to nonfinancial assets and liabilities.

3. Paragraph 8 should be clarified to state that changes in valuation techniques may result from new transactions that take place, for example, a third-party investment.

4. We note that under paragraph 23, when using Level 3 estimates, it appears any type of adjustment can be made to a quoted price, whereas such adjustments are expressly proscribed under Level 1 and Level 2 estimates. Therefore, entities could easily move themselves from Level 1 or Level 2 and attain the adjustments they would otherwise be unable to consider. We believe this should be clarified by providing general principles on adjustments to quoted market prices that apply broadly to all levels.

**Issue 6: Level 1 Reference Market**

We generally agree that the Level 1 reference market requires that an entity have immediate access to an active market in order to use a quoted market price. However, for the reasons described below, we are concerned with the requirement for an entity to base fair value on the "most advantageous market" when the entity has immediate access to multiple markets. We prefer the entity focus on the most predominant market for which the instrument is principally traded (i.e., the principal market with the most breadth and depth).

1. **Inconsistent with ASR 118 and the fair value measurement objective.** We prefer the ASR 118 approach of using the market for which a security is "principally traded",

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11 Currently paragraph 21 implies there is a requirement to use multiple valuation techniques, whereas paragraph 22 (by the reference to "if") implies it is not always required to use multiple techniques.

12 We recognize that in paragraph C46 the Board makes reference to the principal market. If the Board intended to allow the use of the most advantageous market only when there is no principal trading market, then we believe this should be made clearer in the ED.
which is presumably the most active and liquid market with the most breadth and depth. This would eliminate the possible inconsistency under the “most advantageous market” approach that may result in different entities reporting different values for the same identical asset or liability. We do not believe the reporting of different values for the same identical asset or liability based on the reference market is consistent with the fair value measurement objective and, in particular, the last sentence of paragraph 5, which states “In all cases, that price shall be estimated without regard to an entity’s intent to currently enter into such a transaction.”

2. **Conflicts with broad principle of using marketplace information.** We believe the use of the “most advantageous market” conflicts with the broad principle of using marketplace information as opposed to entity inputs. The subjective nature of the market that is most advantageous to the entity results in a direct conflict with the general market’s perception and the statement in paragraph 12 that “market inputs shall be determined based on information that is... from sources independent of the entity.”

3. **Conflicts with bid-ask price guidance.** We are unclear of how recording the high end of an amount for a long position and the low-end of amount for a short position under the “most advantageous market” approach relates to (and is consistent with) the essentially opposite guidance when using bid-asked prices.

4. **Consideration of transaction costs.** We do not understand the conceptual basis for determining the “most advantageous market” by considering the costs to transact, but yet using a price to estimate fair value that is not adjusted for the transaction costs. We believe that the “most advantageous market” approach is based on a presumption that fair value represents the amount at which the entity can sell an asset or have a liability assumed (and not necessarily the market’s perception). While we believe this conflicts with the broad fair value objective, if the Board chooses to retain this “for sale” approach, then we believe the fair value should also be reduced by the costs to sale. Otherwise, the fair value results may not be comparable or economically rational. For example, we note, in item (b) of paragraph B9, that an entity values an asset at $25, based on the greater of two market opportunities after giving consideration to transaction costs (although such costs are not included in the fair value). Continuing on with the example, if another entity only had access to Market B, then that entity would record the price at $35. Notwithstanding how such disparity in prices could occur absent other unrecognized elements to the transaction, we do not agree with the anomalous results that occurs without including the costs to transact. In this example, one entity records the fair value at $35 (although net realizable value after transaction costs is $15) and the other entity records a lower value of $25 (although net realizable value after transaction costs is $20). This does not seem consistent with other guidance in the ED and it does not seem to provide information that is useful to investors or creditors. We also believes it results in a direct conflict with the lower-of-cost or market approach to valuing inventories.

5. **Potential for abuse.** We believe the “most advantageous market” approach could result in abuse in practice and an unfair advantage (e.g., if large market makers have the ability to “make the most advantageous market” by transacting near the close of trading).

6. **Relationship with last quoted price.** We are unsure of how the “most advantageous” market relates to the use of the last quoted price. For example, many entities may determine that the use of electronic communication networks (ECN) is the most advantageous or efficient market. However, these markets generally have closing prices after the standard close of the NYSE and NASDAQ markets and, therefore, the ultimate determination of the “most advantageous market” could differ depending on the time the security is traded. The relationship of this to the subsequent events guidance is unclear.
7. **Overly burdensome.** We believe the requirement to consider how many markets an entity has immediate access to and then determine which one is the most advantageous is overly burdensome as it would depend on many different factors for different entities. We also do not believe there should be artificial changes in fair value based on a change in the market selected for determining fair value.

8. **Broad application of guidance.** We also recommend the Board clarify that the ultimate approach taken to determining the market when an entity has immediate access to multiple active markets applies broadly to all three levels of fair value estimates.

### Issue 7: Pricing in Active Dealer Markets

**General**

We believe the guidance on the use of bid-asked prices in ASR 118, which provides principles for an entity to consider in adopting and applying a consistent accounting policy that best reflects the entity’s facts and circumstances (while still providing appropriate boundaries to prevent inappropriate uses of bid or asked prices) is preferable to the extremely prescriptive and “rules-based” approach outlined in the ED. We also believe the ASR 118 approach is more aligned to international convergence and practice.

We understand the guidance in the ED was adopted in order to satisfy broker-dealer entities; however, we are unaware of the empirical evidence providing support for the Board’s basis for conclusions in paragraph C50. We believe adopting an approach similar to ASR 118 allows broker-dealers the ability to choose the accounting specified in the ED, but does not inappropriately restrict other entities for which that accounting is not most appropriate. The Board even recognizes in paragraph C50 that a midpoint price that averages multiple third-party dealer quotes may result in a price more akin to an exchange-equivalent price that better aligns with the fair value definition. We agree with this statement and we also believe that a midpoint price, adjusted for liquidity and credit risk, is also more consistent with how certain instruments, such as non-exchange traded derivatives, are priced in the market.

Assuming the Board retains the bid-asked requirements in the ED, we do support the general concept of offsetting exposures subject to certain clarifications. However, we believe the best approach would be to not mandate the bid-asked price guidance as currently expressed in the ED, which may obviate the need for the detailed guidance on offsetting.

**Use of Bid-Asked Prices for Fair Value Measurements**

Paragraphs 11(b), 17 and C47 state that in active dealer markets, bid and asked prices are more readily and regularly available than closing prices. The Board refers to an over-the-counter market as an example of a dealer market.

It is not exactly clear as to what types of financial instruments are valued on the basis of bid-asked prices as opposed to closing or settlement prices and, in particular, what dealer markets the Board is referring to. We believe additional guidance is needed in this area, including a reconsideration of the definitions of markets in paragraph 11 focusing on whether the instrument is a standardized contract or is a non-standardized contract that gives rise to unique credit and liquidity risks. We also believe the Board should address in more detail those active markets with standardized contracts that have readily available bid and asked prices without relevant closing or settlement prices. Lastly, we believe the Board should clarify whether the bid-asked guidance applies only to Level 1 estimates or similarly applies...
to Level 2 and Level 3 estimates. If it only applies to Level 1 estimates, then we believe the guidance is effectively irrelevant for all non-standardized contracts that give rise to unique risks due to credit, prepayment, and liquidity since the bid and asked prices would merely represent inputs that can be adjusted as necessary under Level 3.

We understand that markets for financial instruments fall into two broad categories - cash markets and derivative markets. With respect to cash markets, most instruments that are actively traded have closing or settlement prices, which would be used (for both exchange-traded and over-the-counter markets). With respect to derivatives markets, there are exchange-traded and over-the-counter markets. In exchange-traded derivatives markets, the contracts are standardized, there is essentially no credit, prepayment or liquidity risk, and closing or settlement prices are ordinarily available (thereby obviating the need to look to bid and asked prices). In over-the-counter derivatives markets, in most all cases the contracts are non-standardized and therefore give rise to specific counterparty credit, prepayment and liquidity risk (thereby not resulting in a Level 1 estimate). This concept was inferred in paragraph 24 of FAS 107, but appears to have been lost in the ED.

We give this background because we believe in many cases the bid-asked guidance is not the only relevant input in valuing non-exchange traded contracts, although entities may build curves with bid-asked prices used as market inputs. In addition, we believe that limiting the bid-asked price guidance to Level 1 estimates obviates its use for most instruments since, in many cases, the bid-asked prices would just be market inputs under Level 2 or Level 3 estimates, which could be adjusted in accordance with paragraph 23.

Additionally, consistent with our comments on Issues 5 and 6, we note that the requirement to use bid and asked prices as established results in asymmetry for the two parties to the instrument, which we believe conflicts with the general definition of fair value. We believe that since trades most often occur somewhere in between the bid and asked price, the use of the mid-market price may be the best estimate of fair value and more consistent with definition of fair value. Next, we draw your attention to the ability of an entity to make the market with a late trade or situations where the last trade is not reflective of the market, hence one of the reasons the CBOT and NASDAQ have adopted standards for adjusting late trades to best reflect the closing or settlement price. And last, we note that the approach taken, which was to minimize the impact of recording upfront-unrealized profits and losses (see paragraph C50) still does not fully accomplish that objective. For example, if an entity buys at the midpoint of the bid and asked price near the close of trade (i.e., the bid is $20, the asked is $22, and the entity pays $21) they would record an immediate loss at the end of the day by recording the ending value at the bid price (in this example, a $1 loss). We believe allowing flexibility in an entity's accounting policy could help alleviate our issues.

In summary, we propose that entities be given the flexibility of applying an accounting policy that is most suitable to their circumstances for all levels of fair value estimates (similar to ASR 118). We also believe that additional guidance on the types of instruments and markets for which bid-asked prices may be more relevant and regularly available for valuing financial instruments is necessary, whether the current bid-asked guidance in the ED is retained or a more flexible approach is adopted. And last, more guidance is needed on the relationship

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13 As noted in our comments above, certain derivative contracts are priced based on mid-market prices adjusted for credit and liquidity risk.
between the guidance on markets in paragraph 11 and whether the related instruments are
standardized or non-standardized and the effects on fair value of factors such as credit risk,
prepayment risk, and liquidity risk that arises in valuing non-exchange traded instruments.

**Offsetting Exposures**

Assuming the Board retains the current guidance on bid-asked measurements\(^{14}\), we support
the concept of offsetting; however, we believe the final guidance should state that offsetting
is not required on a specific instrument basis, but may be applied based on the manner in
which an entity manages risk. We believe such a portfolio approach is consistent with risk
management techniques and with the ability to hedge on a portfolio basis under FASB
Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In this
regard, we believe offsetting should be allowed on a broad level (i.e., among all levels of the
hierarchy) and not limited to either Level 1 estimates or on an instrument-by-instrument
basis. We support an entity’s ability to apply offsetting as an accounting policy decision as
long as it is applied consistently across periods and consistent with the entity’s risk
management and hedging activities.

We believe that such changes are needed to better reflect the reality of how entities manage
risk and to not produce otherwise anomalous results. In practice, entities often manage risk
at an aggregated risk characteristic level. Entities often separate instruments into their
different risk characteristics and manage such risks using multiple offsetting instruments.
Many entities do not manage risk on an instrument-by-instrument basis. We believe this is
evident in the market and should be reflected in the offsetting of exposures. In other words,
we do not believe that offsetting should be limited to an instrument-by-instrument basis\(^{15}\) or
to certain fair value hierarchy levels since this is not consistent with how risk is mitigated in
practice (see examples below). To otherwise take this approach would disregard the swap
market, which is one of the most prevalent ways to offset exposures. We also believe
adopting any approach that does not allow for flexibility in offsetting exposures may conflict
with certain provisions of FAS 133.

For example, an entity may hedge an exchange-traded stock by entering into an over-the-
counter equity swap as allowed by FAS 133. As another example, entities often enter into
exchange-for-physicals to manage risk. In addition, in some cases instruments are separated
into their risk elements for risk management purposes. It is also common for multiple
instruments (such as non-exchange traded derivatives) to be used to mitigate multiple
different risks arising in a single instrument (such as an exchange traded instrument). For
example, an entity could use a credit default swap and an interest rate swap to manage
different risks in a publicly traded bond. And to add to these individually managed
exposures, entities may use similar aggregated positions or portfolios of instruments to offset
aggregated risks from long and short positions. We believe these examples, which are not
all-inclusive, provide support for allowing the offsetting concept to be applied in a manner
consistent with an entity’s risk management strategies.

\(^{14}\) Otherwise, if the FASB allows a more flexible approach, the offsetting concept is less relevant.
\(^{15}\) We are not opposed to allowing offsetting on an instrument-by-instrument basis if entities manage risk
in this manner; however, we do not believe such an approach should be required.
Issue 8: Measurement of Blocks

Blockage Factors
We disagree with the Board’s decision to not address unit of account issues, including, specifically, the Board’s decision to not allow blockage factors for all unrestricted securities because existing practice is not consistent with the definition of fair value in the ED.

We believe that if an entity holds a large position of a security that cannot be absorbed at individually traded prices, the true fair value of that asset (i.e., the amount at which the holding can be exchanged) should reflect a block discount if the total proceeds that can be received in an exchange are less than the product of units held times the quoted price for an individual trading unit. We believe the dynamics of supply and demand in the marketplace should define the fair value, and, therefore, to the extent an excess supply will result in a discount, it should be reflected in the fair value. We also note that if we applied the reference market approach in paragraph 16 the fair value that could be obtained in the most advantageous market would necessarily be less than the price per unit other market participants could receive for smaller, more liquid, holdings (the difference representing the block discount). Therefore, we urge the Board to reconcile the apparent inconsistency in the guidance on blockage factors and the “most advantageous market” approach.

While we acknowledge that blockage factors are most relevant for investment companies and broker-dealers that record investments at fair value (as opposed to other entities that would generally apply the equity or consolidation methods of accounting when the large position exceeds 20% or more), we believe the Board should allow the use of blockage factors either for all entities or none. In our opinion, where a discount is the reality in determining fair value, as defined, blockage factors should be allowed to be consistent with the definition of fair value. In essence, the blockage factor can be viewed as a noncontractual liquidity restriction, and therefore discounted consistent with the guidance on restricted securities. Otherwise, we believe that entities that hold large positions will never be able to truly reflect the holdings at fair value until the position is sold at which point the transaction price will confirm the blockage discount that should have been applied. This creates an unnecessary gap between the accounting and underlying economics.

We understand that the Board’s decision to not allow blockage discounts and to require the bid-asked spread guidance was premised in part on not recognizing gains and losses until they are realized (see paragraph C50). However, in this regard, we draw your attention to the fact that such issues will still occur, for example, if an entity buys a large block of a security at a discount to market and then immediately writes it up to fair value as determined by quoted price for an individual unit.

Lastly, with respect to blockage discounts, we question the prohibition of using a blockage discount in Level 1 estimates; however, per review of paragraph 23, such discount would be allowable in terms of market inputs for a Level 3 estimate. We believe the guidance should be consistent for all fair value measurements in the hierarchy.

Control Premiums
We question the lack of any reference to control premiums in the ED. Per the definition in paragraph C32, one could infer that the Board intended for a blockage factor to be either a discount or premium (and therefore encompass the notion of a control premium). We
believe, however, that the two should be appropriately distinguished in the ED with the guidance on each being consistent. This is not currently the case, as paragraph B3 and the proposed revisions to paragraph 23 of FAS 142 both imply that considering control premiums in fair value estimates is acceptable. While we agree with this notion because it is consistent with the definition of fair value and market participants do place control premiums in their valuation models, we believe it is inconsistent with guidance for blocks of securities.

**Issue 9: Level 3 Estimates**
See our comments on Issue 5 above.

**Issue 10: Restricted Securities**

*General*
We agree with the guidance on restricted securities that was taken from ASR No. 113, *Statement Regarding Restricted Securities*. We believe that guidance lays out the principles to consider while allowing for sufficient flexibility to arrive at a "good faith" fair value estimate. However, we do not understand how this fits into the ED’s fair value hierarchy.

*Specific Comments on Paragraphs B17–B19*
We question whether a restricted security falls within Level 2 or Level 3 of the hierarchy. The guidance appears akin to Level 2 since the value is based on an otherwise identical security, although the judgmental subjective nature of the adjustment appears contrary to the requirement for an objectively determinable adjustment under Level 2. We believe the Board should be clearer, because if this were a Level 3(a) adjustment under the market approach, the ED would seem to require that another valuation technique be used to validate the estimated fair value. If not, then this would be an exception to the general requirement for Level 3 estimates. This further illustrates the comment above on the need to further clarify the differences between Level 2 and Level 3(a) fair value estimates.

We also are unclear as to the Board’s intent with respect to valuing restricted securities for which there is not an *identical* unrestricted security (which is often the case). We are unsure of whether the Board is implying that in these instances the fair value estimate is a Level 3 estimate, whereas if an otherwise identical security did exist, the valuation adjustment to the restricted security is a Level 2 estimate even though such adjustment could be as subjective as the Level 3 adjustment when an otherwise identical security did not exist. In any event, we believe more comprehensive guidance is necessary for valuing restricted securities when there is not an identical unrestricted security.

*Other Comments*
We do not understand the inconsistency between the ED approach to accounting for restricted securities and the guidance in the ED on use of blockage factors and the guidance in the Proposed Statement of Financial Accounting Standards, *Share-Based Payment*. We believe that allowing a discount for restricted securities, as defined in the ED, and not allowing a discount for blockage, which can be viewed as an implicit restriction on selling at the individual trading unit level, is inconsistent. We also do not agree with nor understand the inconsistency of the guidance on allowing discounts for restricted securities, as defined in the ED, and the lack of similar guidance on restriction adjustments arising from the non-transferability provisions of employee stock options. We do not believe the option-pricing models similarly capture the restriction/liquidity discount related to fully vested employee
stock options. Therefore, we believe that the guidance on share-based payments should be
reconciled to the fair value measurement ED before the final pronouncements are issued.

**Issue 11: Fair Value Disclosures**
The additional disclosures may not seem unreasonable on their own; however, we question
the current "overload" of disclosures and especially the increased amount of disclosures
required in recent standards. We also strongly disagree with requiring these disclosures
quarterly, as they are neither cost-beneficial nor necessary for recurring fair value
measurements. And we are concerned about the confusion that will arise with quarterly
unrealized gain/loss information in relation to the annual unrealized gain/loss information
where many of the quarterly unrealized positions will have been realized by year-end.

We also question the usefulness to investors and creditors of the proposed disclosures and
whether providing information with respect to unrealized gain/loss information for assets and
liabilities held at year-end, especially without the context of total revenues and expenses and
related realized gains/losses, is useful. And we disagree with providing fair value disclosures
that do not include all accounts measured at fair value (i.e., those not included in the scope in
paragraph 2). We believe that the lack of disclosures for all accounts measured at fair
value, combined with selective disclosures of unrealized gains/losses, provides a distorted
view of fair value information in the financial statements. We question the usefulness of
such information and urge the Board to reconsider fair value disclosure information in its
entirety in the context of what reasonable users of the financial statements need. We believe
that fair value disclosures focused on the transparency of an entity's valuation models and
significant assumptions would be most useful to financial statement users.

We also draw your attention to the fragmented requirements and relationship between the fair
value disclosures in this ED and FAS 107. We support a consolidation of all required fair
value disclosures into one standard. If the ED is revised to be a Concepts Statement as we
suggest, all of the disclosures could be included in an amendment to FAS 107. Otherwise,
we support the rescission of FAS 107 and inclusion of any remaining relevant guidance in
one final fair value FASB Standard.

**Issue 12: Effective Date**
We believe certain of the ED requirements will require significant system changes. In light
of these changes and the array of other new guidance required to be implemented, including
accelerated filing requirements for SEC registrants, we suggest the effective date allow for a
minimum of a one-year implementation period from the date a final pronouncement is issued
for all entities

We also suggest clarifying in the body of the standard that any cumulative
effect change related to paragraph 17 is calculated for relevant assets and liabilities existing
as of the implementation date using a "catch-up" approach as referred to in paragraph C72.

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16 We note that in paragraphs 26 and C18, the Board encourages disclosures about inventory and other
remeasurements that represent "current amounts", although we are unsure of the completeness of such
other pronouncements or the intended meaning of "current amounts."

17 We draw your attention to our proposal for expanding the scope to address many important unresolved
issues, which could result in a substantial delay in issuance of a final pronouncement.
Issue 13: Other Issues
Specific matters for consideration by the Board in addition to the issues discussed in the body of our letter and the additional matters noted in the appendix include:

- The impact of an entity's ability to “make a market” on fair value, including the affect of trader transaction costs on market making activities.
- Additional guidance on the use of liquidity and market discount factors for private equity investments and recent IPOs with extremely volatile trading patterns.
- The principles that result in the ability to invoke the practicality exception, including how this affects the use of fair value measurements for recognition and disclosures purposes.
- The impact of the existence (or lack of existence) of active markets on the use of fair value measurements, for example, whether it is appropriate for entities to record non-securitized financial instruments at fair value if there is an active exchange market.\(^{18}\)
- Additional guidance on how credit risk, prepayment risk, and liquidity risk affects the fair value measurements of non-exchange traded instruments.
- The general issue of lack of symmetry on the buy and sell side (e.g., “most advantageous market”, bid and asked guidance), including the reconciliation to the fair value definition.
- The impact on fair value of transactions with multiple elements, explicit or derived.

Appendix D - Amendments to Existing Pronouncements
We support amendments to existing pronouncements, including clarification of terms such as “market value”, “market”, and “fair market value”, and “fair value.” We have only minor comments on the proposed amendments to other pronouncements although we recognize that a significant effort will also be required to amend other existing pronouncements, including those issued by other standard-setters\(^ {19}\). Specific comments are as follows:

- APB 21 – We do not agree with the deletion in paragraph 13 without providing similar guidance in the ED. As noted above, we recommend adding more guidance beyond that in paragraph A10 on the selection of the appropriate rate. We believe such guidance should include at a minimum that being deleted in APB 21 paragraph 12 along with additional factors, such as volatility, prepayment risk, default risk, and other market risks.
- FAS 107 – We believe additional guidance on “custom tailored” contracts similar to that in paragraph 24 of PAS 107 would be very helpful. See also our comments above on the use of internally developed models and the valuation of non-exchange traded contracts.
- FAS 143 – We do not understand the deletion in paragraph A20, including whether this implies that a different measurement objective exists.
- Where references to fair value measurements have been deleted, it would be helpful to provide via footnote a reference to the final pronouncement on fair value measurements.

Appendix E: References to Existing Pronouncements
We support the issuance of this appendix and suggest it be expanded to include all other relevant GAAP, including that issued by other standard-setters.

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\(^{18}\) This may be an issue to consider as part of the elective fair value measurement project.

\(^{19}\) For example, the definition of fair value in SOP No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer refers to paragraphs 68-70 of FASB Statement No. 140 which is being proposed to be deleted in Appendix D.