September 10, 2004

Letter of Comment No: 76
File Reference: 1201-100
Date Received: 9-69-04

Mr. Lawrence Smith, CPA
Director, Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: June 23, 2004 Exposure Draft (ED) of a Proposed Statement of Financial Accounting Standards, Fair Value Measurements [File Reference 1201-100]

Dear Mr. Smith:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the above-referenced ED and is providing the following comments for your consideration.

GENERAL COMMENTS

TIC agrees with the concepts underlying the fair value measurement methodology in the ED. TIC appreciates the Board's efforts to promote a more consistent application of fair value principles. The guidance contained in the ED is necessary and helpful.

However, TIC has some general concerns with the migration to fair value measurements for all assets and liabilities. TIC expects a large percentage of its constituency will lack the skill set to understand and apply the fair value methodology outlined in the ED.

TIC's constituency will face especially challenging implementation issues because most fair value measurements for the assets and liabilities of smaller entities will be Level 3 estimates. In particular, TIC is concerned that the multiple-valuation technique will be too burdensome to apply across-the-board both in terms of cost and time, especially given the difficulty that many companies will have in finding quoted prices for certain types of assets and liabilities.

The complexity of this ED will challenge both auditors and preparers in ways that will ultimately reduce the reliability of the estimates and increase the audit risk associated with fair value measurements.

As a partial solution, TIC recommends that the final standard include a flowchart that would illustrate step-by-step the fair value measurement process—highlighting the decision points and data-gathering efforts. TIC also believes many more examples are needed that show how the fair value hierarchy would apply to the types of assets and liabilities smaller entities typically face.

TIC also has concerns from the user perspective. As the use of fair value increases, users will have to become accustomed to much more volatility in financial statements over time. TIC believes that educational programs should be adopted that will target the needs of users so that they may be advised of what to expect and how the increased use of fair value estimates will affect financial statement analysis. Furthermore, TIC did not find the new disclosures particularly helpful to users and recommends that additional effort be made to improve them.

TIC suggests that the Board conduct a field test of the ED among nonpublic companies before it is finalized. The field test should include smaller nonpublic companies so that their issues and problems might be addressed in the final standard. Part of the field test should include feedback from lenders and other financial statement users regarding the new disclosures and potential income statement volatility.

SPECIFIC COMMENTS

Definition of Fair Value

Issue 1: This proposed Statement would define fair value as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties" (paragraph 4). 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. Will entities be able to consistently apply the fair value measurement objective using the guidance provided by this proposed Statement together with other applicable valuation standards and generally accepted valuation practices? If not, what additional guidance is needed? (Specific aspects of the guidance provided by this proposed Statement are considered below.)

Attaining an acceptable level of consistent application, reliability, and relevance for fair value measurements in a cost beneficial manner is a critical issue for nonpublic entities since most of their fair value measurements will be categorized as Level 3 estimates. An efficient, reliable process for applying the necessary judgment to develop highly subjective Level 3 estimates will be essential to avoid significant practice problems in implementing the new standard. The ED does not adequately describe the process or provide enough information to understand how certain inputs are to be derived. TIC is concerned that, in many cases, an entity may be required to establish three or four different estimates for each asset or liability to be valued under Level 3. The estimate to be used for the financial statements would then be chosen based on the exercise of judgment. TIC questions the cost/benefit of such fair value measurements given the

extensive time required to develop them in relation to the limited reliability that may be derived.

The ED prioritizes the communication of relevant information over the need for reliable information. TIC members believe that investors' reliance on cash flows indicates they value reliability over relevance. To enhance reliability, TIC encourages the FASB to provide as much additional guidance in the final standard as possible, especially since smaller firms and preparers do not have the depth of resources of their larger counterparts.

TIC believes certain terminology in the ED needs to be changed or enhanced to ensure consistent application of the final standard.

TIC members take issue with the notion that "generally accepted valuation practices" exist as a specific, identifiable body of knowledge that has truly achieved general acceptance. These concepts are evolving among various standard-setting bodies, including the Accredited in Business Valuation (ABV) Task Force at the AICPA. The ABV Task Force is making efforts to codify such standards, but competing groups exist. It is our understanding that there are not yet any such generally accepted standards.

Therefore, TIC is concerned that, if the ED is finalized as written, the reference to "generally accepted valuation practices" will not be consistently applied. Valuation reports prepared by experts in the field, including CPAs, do not currently cite these practices.

The ED cites the Appraisal Foundation's Uniform Standards of Professional Appraisal Practice requirement to consider valuation techniques that apply market and cost approaches, as well as an income approach (Paragraph C42). If this practice is the only one critical to the implementation of this ED, then there would be no reason to make a generic reference to all of the Foundation's standards. If the FASB has a preference for particular valuation practices, these should be named specifically in the standard without implying that a generally accepted body of knowledge exists.

Given the differences that exist in actual practice and the lack of agreement on a generally accepted body of knowledge, TIC suggests that the final fair value standard include guidance that would acknowledge potential differences between a GAAP fair value measure and other fair value measures. Such guidance would be useful to preparers who need to engage specialists to calculate fair values and to CPAs who are seeking to rely on such specialists in connection with financial statement audits.

TIC believes the definition of fair value in paragraph 4 of the ED should be more robust and incorporate certain critical elements from paragraph 5. Specifically, the definition should clarify the terms "knowledgeable" and "willing parties." TIC noted that IRS Revenue Ruling 59-60, which defines "fair market value" and is cited in paragraph C27 of the ED, does incorporate similar explanatory language in its definition. TIC

recommends the phrase "knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction" replace the word "knowledgeable" in paragraph 4 to indicate the level of knowledge expected.

Similarly, paragraph 5 provides context for the meaning of "willing parties" by stating:

Fair value presumes the absence of compulsion (duress).

TIC recommends the clause be added to paragraph 4 so it is clear the exchange must take place free of any compulsion to buy or sell.

Paragraph 5 should also be modified to clarify the guidance that states:

...the estimate is determined by reference to a current hypothetical transaction between willing parties.

The reference to a "hypothetical transaction between willing parties" may be misinterpreted as pertaining to a specific buyer. To clarify the Board's intent, TIC would prefer to see the discussion of "Fair Value versus Investment Value" from Appendix B, paragraph B2, incorporated within paragraph 5 of the final statement. The importance of estimating fair value from a marketplace perspective versus the individual investor perspective is an extremely important distinction that preparers and practitioners may not recognize. At a minimum, the above sentence from paragraph 5 should be modified to indicate that willing parties are marketplace participants in this context and are not specific individuals.

Valuation Techniques

Issue 2: This proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement [SFAC] No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, for using present value techniques to estimate fair value (Appendix A). Is that guidance sufficient? If not, what additional guidance is needed?

In general, TIC believes that most of the guidance in Appendix A is sufficient since the majority of practitioners understand present value concepts and the existing guidance in SFAC No. 7.

However, TIC noted that additional guidance is needed for certain paragraphs in Appendix A. Paragraphs A17 and A18 of the ED are designed to explain the expected present value technique, which is illustrated by an example in paragraph A16. Paragraph A18 states that the two methods for calculating the "market required risk premium" yield the same result. The explanation is not clear as to why the results are the same. Furthermore, the analogy to the discount rate adjustment technique is not helpful. These paragraphs should be rewritten in plainer English and the explanations should be enhanced for clarity.

TIC questioned a specific statement in paragraph A19 of the ED that implies that an array of probable cash flows under the expected present value technique could be developed even if the entity has access to only "limited data." TIC does not understand how the data in the paragraph A16 example would be obtained. Paragraph A19 talks about how to develop the methodologies for the calculations but never clarifies exactly how the entity would obtain the data. It would seem that the "application of the expected present value technique" would be restricted if the data were largely unavailable. The ED would benefit from a discussion of the issues and problems that the entity would encounter in developing cash flows under a "limited data" scenario.

Paragraph A19 states that each application of the expected present value technique involves, among other things, "determining whether to apply a continuous or discrete probability distribution..." TIC recommends this discussion be expanded to provide more guidance on how and when to apply a continuous versus discrete probability distribution. Without such guidance, TIC believes consistency will be tough to achieve given the judgments involved.

Active Markets

Issue 3: This proposed Statement would clarify that valuation techniques used to estimate fair value should emphasize market inputs, including those derived from active markets. In this proposed Statement, active markets are those in which quoted prices are readily and regularly available; readily available means that pricing information is currently accessible and regularly available means that transactions occur with sufficient frequency to provide pricing information on an ongoing basis. Is that guidance sufficient? If not, what additional guidance is needed?

For our types of clients and situations, this guidance is sufficient since these market inputs are generally not available to our constituency. However, see our comment under Issue 5 below regarding market inputs that are not derived from active markets.

Valuation Premise

Issue 4: This proposed Statement would provide general guidance for selecting the valuation premise that should be used for estimates of fair value. Appendix B illustrates the application of that guidance (Example 3). Is that guidance sufficient? If not, what additional guidance is needed?

TIC believes this guidance is sufficient.

Fair Value Hierarchy

Issue 5: This proposed Statement would establish a hierarchy for selecting the inputs that should be used in valuation techniques used to estimate fair value. Those inputs differ

depending on whether assets and liabilities are identical, similar, or otherwise comparable. Appendix B provides general guidance for making those assessments (Example 4). Is that guidance sufficient? If not, what additional guidance is needed?

In determining whether adjustments to quoted prices are appropriate, the entity must decide whether the assets or liabilities being valued are identical, similar or just "otherwise comparable" to the prices in the marketplace. Example 4 (Appendix B) is understandable on its face but is difficult to comprehend within the context of the Fair Value Hierarchy. Example 4 is unclear as to whether the asset or liability being valued must be compared to "quoted prices in active markets" in every case. The definition of "active market" for the typical transactions of our constituency is unclear. TIC also believes more guidance is needed to illustrate the thought process leading up to the assessment of "identical, similar or otherwise comparable assets and liabilities" when no active market exists and the only data available is an isolated transaction or two.

TIC recommends additional examples be developed providing specific illustrations of how the similarity assessment would be performed for Level 1 and Level 2 estimates, using transactions smaller nonpublic companies would face routinely. In addition, many small businesses will lack the sophistication to develop entity inputs. Illustrations comparing how the fair value measurement process differs when active markets exist versus when they don't should be considered. Suggested examples would be interest rate swaps (i.e., to clarify whether they would always be level 2 estimates), asset retirement obligations, construction contracts, noncompetition agreements, stand-ready obligations under guarantees, etc.

Without the additional guidance suggested above, TIC is concerned that significant consistency issues could arise based on the Level chosen by the client versus the auditor.

Furthermore, TIC suggests the Board develop a flowchart as an appendix that would outline the step-by-step sequence involved in performing fair value measurements. It would serve as an overview of the process that would apply to every transaction and a guide that would help practitioners and preparers understand the key decision points and the key data-gathering points along the way. Without this flowchart, TIC is concerned that confusion will result regarding the appropriate path to follow in the hierarchy and consistent application of the standard will be difficult to achieve.

Level 1 Reference Market

Issue 6: In this proposed Statement, the Level 1 reference market is the active market to which an entity has immediate access or, if the entity has immediate access to multiple active markets, the most advantageous market. Appendix B provides general guidance for selecting the appropriate reference market (Example 5). Is that guidance sufficient? If not, what additional guidance is needed?

TIC believes the guidance is sufficient, but the cost/benefit of comparing different markets and choosing the most advantageous is suspect. If the small company can identify one market, the ED does not clarify how the company (or its auditor) would know if there are other markets that may be more advantageous and how much time they would have to spend researching potential other markets.

For example, some investment companies use pricing services to value investment assets that are traded infrequently. When the auditor applies auditing procedures to the valuation performed by the pricing service, he/she may need to obtain an estimate of fair value from more than one pricing source. As a result of this and other procedures, differences of opinion between the auditor and the client regarding a fair value measurement may arise more frequently. Additional guidance is needed so that both parties understand how to evaluate contrary quotes from two or more pricing services.

Pricing in Active Dealer Markets

Issue 7: This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. Do you agree? If not, what alternative approaches should the Board consider?

TIC does not take issue with the active market valuations being proposed for long and short positions.

Measurement of Blocks

Issue 8: For unrestricted securities with quoted prices in active markets, many FASB pronouncements (including FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments) require that fair value be estimated as the product of a quoted price for an individual trading unit times the quantity held. In all cases, the unit of account is the individual trading unit. For large positions of such securities (blocks) held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries (the Guides) permit fair value to be estimated using blockage factors (adjustments to quoted prices) in limited circumstances. In those cases, the unit of account is a block.

The Board initially decided to address that inconsistency in this proposed Statement as it relates to broker-dealers and investment companies. The Board agreed that the threshold issue is one of determining the appropriate unit of account. However, the Board disagreed on whether the appropriate unit of account is the individual trading unit (requiring the use of quoted prices) or a block (permitting the use of blockage factors). The majority of the Board believes that the appropriate unit of account is a block. However, the Board was unable to define that unit or otherwise establish a threshold criterion for determining when a block exists as a basis for using a blockage factor. The

Board subsequently decided that for measurement of blocks held by broker-dealers and certain investment companies, current practice as permitted under the Guides should remain unchanged until such time as the Board fully considers those issues.

For those measurements, do you agree with the Board's decision? If applicable, what approaches should the Board consider for defining a block? What, if any, additional guidance is needed for measuring a block?

TIC agrees with the Board's decision and concurs that guidance is needed for practitioners regarding blockage discounts.

Level 3 Estimates

Issue 9: This proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort (Level 3 estimates). Appendix B provides general guidance for applying multiple valuation techniques (Examples 6-8). Is that guidance sufficient? If not, what additional guidance is needed?

In general, this guidance is sufficient in a perfect world where quoted prices for all kinds of market transactions are available. However, entities making estimates under Level 3 need a better understanding of what fair value measurements really mean in terms of making audit decisions.

TIC believes significant audit issues could arise. For example, assume the entity applies the fair value measurement methodology in good faith and then an actual transaction occurs 12 months later that deviates significantly from the prior estimate. TIC is concerned that the auditor would not be able to determine whether the discrepancy was a true change in fair value in the intervening period or whether it was a bad estimate due to a thin market, the unique nature of the asset or other reasons. Subsequent transactions are typically used to confirm or contradict the reliability of a previous estimate. TIC foresees that the uncertainties noted above will arise more frequently and affect the auditor's ability to perform an appropriate retrospective review, as required by Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit, paragraph 64.

In addition, TIC questions whether the multiple-valuation-techniques approach would change how small companies evaluate goodwill in a business combination. Currently, the goodwill that is booked at the acquisition date is an investment value that is often based on the synergies of the seller. However, the goodwill impairment test will be based on fair value, which will usually be lower than investment value. This ED would effectively change the valuation methodology for goodwill such that many entities would have a goodwill impairment in the first year following the combination. TIC believes this result

is inconsistent with the nature of goodwill and the intentions of FASB Statement Nos. 141, Business Combinations, and 142, Goodwill and Other Intangible Assets.

In the discussion of Benefits and Costs (paragraph C75), the ED states:

...for Level 3 estimates, many entities might need to apply additional valuation techniques and perform additional analysis. The Board acknowledges that those entities might need to make changes to comply with the requirements of this Statement, incurring one-time costs.

Since many fair value measurements for our clients will involve Level 3 estimates, TIC believes the complexity and cost of additional valuation techniques and analysis will create undue hardship for smaller nonpublic entities. TIC's constituency is used to applying only one methodology—the expected present value technique in SFAC No. 7. Although TIC supports the theory underlying the ED, TIC favors the practical simplicity of one consistent measure for Level 3 estimates in order to maintain reasonable costs for the valuations. Given the number of pronouncements that require both initial and subsequent remeasurements, TIC disagrees with the argument above that implies these are "one-time costs."

Restricted Securities

Issue 10: This proposed Statement would require that the fair value of restricted securities be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction. Appendix B provides general guidance for developing those estimates, which incorporates the relevant guidance in SEC ASR No. 113, Statement Regarding "Restricted Securities." Is that guidance sufficient? If not, what additional guidance is needed?

TIC believes the guidance on restricted securities is sufficient.

Fair Value Disclosures

Issue 11: This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. Appendix B illustrates those disclosures. This proposed Statement also would encourage disclosures about other similar remeasurements that, like fair value, represent current amounts. The Board concluded that those disclosures would improve the quality of information provided to users of financial statements. Do you agree? If not, why not?

TIC believes that the illustrative table in paragraph B22 has no added value in nonpublic company financial statements since it will not serve any useful purpose for the users of those statements. TIC expects users will find the disclosure difficult to understand and will be frustrated by its inclusion of irrelevant elements and its omission of key information.

The table is not written in plain English. It does not include a clear explanation of what each column means and never shows that certain numbers in the table are more reliable than others. Rather, the language used in the table presumes that financial statement users have read and understood this proposed standard, which is an unrealistic expectation. (For example, how would the reader know what was meant by "significant market inputs" and "significant entity inputs"?) The table also shows much more information than would ever be helpful to users. It overloads the user with data that cannot effectively be evaluated without having all relevant inputs. The table also fails to convey the notion that the valuation in question is nothing more than an estimate. Until an actual transaction occurs, the entity will have no assurance as to the actual fair value of the asset or liability.

TIC recommends that the maximum required disclosure for nonpublic entities contain several elements. First, the entity should identify the assets/liabilities measured at fair value and describe which ones are based on quoted market values versus those that are subject to estimation. A general statement could be made that quoted prices in active markets for identical assets and liabilities are generally more reliable than estimates based on an entity's own internal estimates and assumptions, which are more subjective and difficult to validate. A detailed table should be optional rather than required. Furthermore, the accounting policy note should indicate that specific assets/liabilities are valued at fair value, which is subject to estimate. TIC also believes the "certain significant estimates" disclosure from AICPA Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties, paragraphs 12-19, is relevant. The footnote would warn financial statement users that a material change in the estimate is at least reasonably possible in the near term. If the volatility of the estimates is clearly disclosed, the user would have no need for a list of inputs to the measurement process.

Effective Date

Issue 12: This proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. The Board believes that the effective date provides sufficient time for entities to make the changes necessary to implement this proposed Statement. Do you agree? If not, please explain the types of changes that would be required and indicate the additional time that would be needed to make those changes.

The stated effective date appears reasonable.

Other Issues

Issue 13: This proposed Statement represents the completion of the initial phase of this project. In subsequent phases, the Board expects to address other issues, including issues relating to the relevance and reliability of fair value measurements and the unit of account that should be used for those measurements. What, if any, other issues should the Board address? How should the Board prioritize those issues?

TIC believes the issues relating to relevance versus reliability are so important, especially in the nonpublic arena, that they should be addressed in this ED.

TIC does not have strong opinions regarding subsequent phases but agrees with the Board's stated intentions as discussed above.

Public Roundtable Meeting

Issue 14: The Board plans to hold a public roundtable meeting with respondents to the Exposure Draft on September 21, 2004, at the FASB offices in Norwalk. Please indicate whether you are interested in participating in the meeting. If so, comments should be submitted before that meeting.

TIC is not interested in participating in the public roundtable meeting.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Stephen M. McEachern, Chair PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees