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September 7, 2004

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

Re: File Reference No. 1201-100, Proposed Statement of Financial Accounting Standards, *Fair Value Measurements*

Dear Ms. Bielstein:

Goldman Sachs appreciates the opportunity to comment on the above-referenced Exposure Draft (the "ED"). The use of fair value is a critical accounting policy for us that we have applied for decades. Our substantial experience in this area gives us a perspective we trust the Board will find helpful.

We support the Board's near-term objective of developing a Statement that clarifies the fair value measurement objective and its application in GAAP. We believe "how to" guidance about fair value measurements is an integral step in achieving the Board's longer-term objective of accounting for all financial instruments at fair value. Our key comments are contained in the main body of this letter, followed in Appendix A by our responses to the specific questions posed in the ED.

### **Interaction between the ED and EITF Issue No. 02-3**

The interaction between the ED and EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," needs to be clearly stated. Issue 02-3 precludes recognition of an unrealized gain or loss at inception of a derivative instrument if the fair value estimate is, in effect, a Level 3 estimate under the ED, using significant entity inputs in lieu of observable market data. Issue 02-3 does not address similar issues in periods subsequent to inception.

Industry practice in applying Issue 02-3 at the inception of a derivative contract is to estimate fair value based on a valuation technique (i.e., a model) that maximizes market inputs and minimizes

entity inputs. If the model value is not observable, for example because it relies on one or more significant entity inputs, the transaction price is deemed to be fair value, the model value is adjusted to arrive at that fair value, and no "Day 1" revenue is recorded. That adjustment to the model value is commonly referred to by industry participants as the "02-3 adjustment."

We follow this approach for a variety of reasons, including control, risk management and systems issues, which are further complicated when multiple significant entity inputs are involved. Most important, we use this approach because we believe the unadjusted valuations resulting from our models represent the real economic value of these transactions. It is these economic risks that we are obliged to manage.

Because Issue 02-3 does not address similar issues in periods subsequent to inception, industry practice with respect to subsequent accounting for the 02-3 adjustment is mixed. Some constituents amortize the adjustment into revenue over the life of the contract in a systematic and rational matter in an attempt to approximate the time decay inherent in derivative valuations, among other reasons. They record the unamortized balance of the 02-3 adjustment in revenue when the model value becomes observable. Other constituents, including Goldman Sachs, do not change the 02-3 adjustment until the model value becomes observable, at which time the entire 02-3 adjustment is recorded in revenue. Both techniques are utilized and accepted by auditors, yet they produce significantly different patterns of revenue recognition.

In our opinion, the ED does not resolve this practice issue. Paragraph 23 states "valuation techniques used for Level 3 estimates shall emphasize market inputs, including quoted prices generated by actual (observable) market transactions, adjusted as appropriate." We understand, based on discussions with the FASB Staff, the Board intends the phrase "generated by actual (observable) market transactions" to be consistent with Issue 02-3 at the inception of a contract. If that is the case, the Board's intent should be made explicit.

With respect to periods subsequent to inception, paragraph 23a provides one reason why an adjustment to quoted prices (i.e., the transaction price) might be appropriate, that is, an input "might not be sufficiently current (stale price)." Paragraph 23a goes on to state "in determining whether a price is stale, an entity should consider the timing of the actual transaction, the frequency of other similar transactions, changes in credit conditions, interest rates, and other market conditions during the intervening period and other relevant factors." We believe paragraph 23a does not resolve this practice issue because it could be interpreted broadly to support either view.

#### *Standard of Reliability and Consistency are Core Issues*

Fundamentally, we believe the core issues related to the interaction between the ED and Issue 02-3 are (1) what standard of reliability should exist at inception before fair value changes are recorded as revenue; (2) should that standard of reliability be consistent over the life of an instrument or should it change; and (3) if it changes, a) when should it change and b) what should be the new standard of reliability.

We understand these are issues the Board chose not to address in the ED because it is deliberating related issues in its revenue recognition project. We urge the Board to reconsider that decision because a final Standard on fair value measurements that does not comprehensively address these issues would be incomplete, especially for those entities that record fair value changes in earnings. It also would not resolve the practice issue we noted above.

Based on our analysis of the ED, we believe the standard of reliability the ED requires at inception is observable market data for all significant inputs, i.e., the same as Issue 02-3. The standard of reliability in the ED changes when the input is considered stale. However, it is not clear to us what level of evidentiary support is needed for the new standard of reliability when significant entity inputs are used.

Conceptually, we believe the standard of reliability should be consistent both at inception and over the life of an instrument, because it aids comparability. Stated differently, the “quality” of revenue should be comparable from period to period and across entities. The conceptual framework indicates comparability, which includes consistency, is a quality that makes accounting information useful for decision making. Comparability interacts with relevance and reliability to contribute to the usefulness of information. Therefore, we believe an approach that does not have a consistent standard of reliability over the life of an instrument, like the approach in the ED, is conceptually deficient.

#### *Single Standard of Reliability*

We believe a single standard of reliability over the life of an instrument is the conceptually superior approach. Under such an approach, an input to a valuation model would not be changed unless the standard of reliability for changing the input was met. We believe there are two standards of reliability that merit consideration by the Board. The first standard is based on observable market data. The other standard is substantive evidence, which we favor.

An observable market data standard is essentially an Issue 02-3 approach applied throughout the life of an instrument (rather than just at inception). An observable market data standard places greater emphasis on verifiability, at the expense of relevance because, at some point, an input is likely to become stale. Intuitively, the longer time passes before an input is updated, the less relevant it becomes. While an observable market data approach would prohibit gain recognition unless all significant inputs were verifiable, it would equally prohibit loss recognition under similar circumstances, meaning economic losses might not be recorded until verifiable. Because it places too great an emphasis on verifiability at the expense of relevance and could result in delayed loss recognition, we do not favor an observable market data approach.

Under a substantive evidence standard, observable market data would be the presumed standard of reliability for an input, unless rebutted by a robust body of evidence that clearly indicates observable market data is no longer the best estimate. Examples of evidence that would rebut the presumption of using observable market data in all cases include similar market transactions, changes in financial ratios, changes in credit ratings, historical market volatilities and correlations, and inputs derived from empirical market data. We believe a substantive evidence standard results in a better fair value estimate compared to observable market data, while still

maintaining a robust level of reliability. Also, a substantive evidence standard would appropriately recognize losses sooner than an observable market data standard. We can provide the Board or Staff with case studies illustrating the application of substantive evidence to real-world examples if this is a path the Board wishes to pursue.

### *Concluding Thoughts on the Interaction between the ED and Issue 02-3*

We believe the interaction between the ED and Issue 02-3 fundamentally relates to the standard of reliability for revenue recognition and the consistency of that standard over time. We believe the standard should be consistent over time and presumed to be observable market data, unless rebutted by a robust body of substantive evidence to support a different valuation. A substantive evidence standard will result in a better fair value estimate.

We understand these are issues the Board chose not to address in the ED because it is deliberating related issues in its revenue recognition project. We do not think waiting is the right approach. A final Standard on fair value measurements that does not comprehensively address these issues would be incomplete and not resolve the practice issue we noted above. Should the Board choose to wait until its revenue recognition project is completed, we believe the FASB staff (or the EITF) should provide interim guidance that resolves the practice issue.

### **Consideration of Own Credit in Fair Value Measurement**

The footnote to paragraph 5 and paragraphs A23 to A27 require that an entity include the effect of its own credit standing in estimating fair value. We fully support this requirement and agree with the Board's reasoning.

We believe including the effect of a change in an entity's own creditworthiness in fair value measurements for liabilities is consistent with the widely accepted view that the asset side of the balance sheet must be adjusted for credit risk in determining fair value. This approach ensures that the credit risk component of a valuation methodology is consistent for both assets and liabilities and that fair value measurements include all risks related to the contractual agreement. Based on market data we have compiled, the market considers the effect of an entity's creditworthiness in the fair value measurement of derivative liabilities and, therefore, the entity has the ability to realize the effect.

Some constituents believe recording a gain as a result of credit deterioration will provide confusing information to the readers of the financial statements. They often cite the example of an entity whose credit standing has significantly deteriorated and how such a gain may not be realizable, presumably because the entity lacks cash or cannot borrow money at any price. While we are sympathetic to that argument (because it suggests an inability to realize the gain), we believe the rare exception should not be the rule.

By considering the entity's credit standing, the entity reflects the impact of changes in fair value in the period they occur as gains or losses, and in future income statements (through higher or lower effective interest rates, respectively). Stated differently, marking to one's own credit spread recognizes that borrowing costs increase when creditworthiness decreases and vice versa.

This approach may require some effort to understand and may not be intuitive, but we do not believe that is adequate reason to depart from the principles of fair value measurement. Credit standing of an entity clearly has an impact on the economic value of that entity's trading liabilities; reflecting that impact on the balance sheet results in a better fair value estimate.

### **Offsetting Risk Positions**

We agree with the provisions of the ED that permit an entity to mark positions held in certain financial instruments to mid-market prices rather than bid- or asked-prices when the risks are offsetting. We note it is common for a financial institution to hold such offsetting risk positions where one of the positions would be measured using Level 1 guidance in the ED and the offsetting position would be measured using Level 3 guidance, or where neither position is measured under Level 1. We recommend that the ED be amended to specifically permit such mid-market pricing in such circumstances; i.e., where the offsetting positions are measured using different levels of the hierarchy, or where neither is measured under Level 1.

### **Block Discounts**

We agree with the decision to continue to permit brokers and dealers in securities to reflect the use of block discounts in valuing large positions in financial instruments. We believe this approach reflects the way many brokers and dealers both purchase and sell securities, and therefore results in more relevant measurements. We agree with the observations in paragraph C36, that valuing such positions using the price of an individual trading unit could result in financial reporting that would not be representationally faithful, and could result in distorted and misleading reporting by giving the appearance of an instant gain upon buying a block, only to be followed by a reported loss on subsequent selling.

### **Most Advantageous Market**

The discussion in paragraph 16 about immediate access to multiple active markets and how fair value is estimated in those situations is unclear to us. For example, assume a dealer owns fuel stored at location A. The fuel can be sold as-is at location A for \$10 or as-is at location B for \$12. The markets at both locations are active (Level 1). If the dealer sells at location B, the dealer must transport the fuel from location A to location B and incur \$1 of transportation costs.

Paragraph 16 states immediate access means that an entity could exchange the asset or liability in its current ("as-is") condition at the quoted price in the reference market *within a period that is usual and customary* for transactions involving such assets or liabilities (emphasis added). The italicized phrase suggests the dealer's access to the market at location B is immediate because the potential exchange (sale) of the fuel at location B could be completed within a customary period of time. If that were the case, based on paragraph 16, the dealer would value the fuel at \$12 at the measurement date and record \$1 of transportation costs when incurred because location B would be considered the most advantageous market. If the trade date occurred at or near the balance sheet date and transportation/settlement occurred in the following accounting period, the dealer would record an extra \$2 of trading revenue in one period (relative to location

A) and \$1 of transportation costs in the next. If that is the Board's intent, we believe it needs to be clarified. If it is, that troubles us because we believe it could result in inappropriate, out-of-period, revenue recognition.

### **Disclosures**

We do not support disclosure of unrealized gains and losses because it would imply such revenues are of a lesser quality than realized gains and losses. If fair value measurements are properly applied, the distinction between unrealized and realized becomes irrelevant. Stated differently, the quality of our revenues is the same whether cash changes hands or not. In addition, providing such information will be costly for us. Our systems do not track cost basis because we do not consider such information relevant or internally useful, for the reasons cited above. We believe disclosure of the end of period fair values, as required by paragraph 25(a)(1) and (2) provides adequate information for users. We urge the Board to delete the requirement set forth under paragraph 25(a)(3).

### **Fair Value Option**

We recognize the Board has asked for comments about how to measure fair value, and not comments about when or whether fair value measurement should be used. However, we note the Board has added a project to its agenda to consider the Fair Value Option. We support this project, and believe the Board should include a fair value option in the final Standard, subject to the same fair value hierarchy as other fair value measurements. That is, we do not support the proposed approach the IASB has put forward in its recent exposure draft amending IAS 39 entitled "The Fair Value Option," which introduces a new verifiability requirement that must be met before the fair value option can be elected. We believe all fair value estimates should be subject to the same fair value hierarchy.

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We appreciate the opportunity to provide you with our views on the ED. If you have any questions regarding our comments, please contact me at 212-902-5675 or Matthew Schroeder, Managing Director—Accounting Policy at 212-357-8437.

Sincerely,

/s/ Sarah E. Smith

## Appendix A: Responses to Specific Questions in the ED

### 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.)

*Response:* We believe the interaction between the ED and EITF Issue 02-3 must be clarified, as set forth in the main body of this letter.

### Valuation Techniques

*Issue 2:* This proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement 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?

*Response:* It does not appear to us that there is any substantive difference between the “Discount Rate Adjustment Technique” described in paragraphs A10-A11, and Method 2 of the “Expected Present Value Technique” described in paragraph A12. The primary risk adjustment for each is an adjustment to the discount rate. We suggest that the difference between the two methods be clarified, or that the distinction between Method 1 and Method 2 of the “Expected Present Value Technique” be eliminated. Other than this, we believe the guidance is both clear and sufficient.

### 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?

*Response:* We believe the guidance provided is consistent with a principles-based approach, and is sufficient.

### **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?

*Response:* We believe the guidance in the Example is sufficient to illustrate the concept of a valuation premise. We would observe that the concept of valuation premise generally will not affect the valuation of financial instruments.

### **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?

*Response:* We find the guidance about Level 1 estimates to be clear. We would urge the Board to consider clarification that financial instruments such as OTC derivatives would fall within Level 3, but otherwise believe that guidance is clear as well. We find it difficult to understand what financial instruments might be included in Level 2 (with the exception of restricted securities), and believe there is potential for confusion about when a financial instrument should be considered to be Level 2 or Level 3. These two levels appear to have much in common, and that the change from Level 2 to Level 3 occurs primarily when the number or magnitude of adjustments to a similar instrument becomes more significant. If that is the intent of the Board, we suggest additional clarification of that view. Otherwise, a clearer definition of Level 2 would be helpful.

### **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?

*Response:* Subject to our comments about “Most Advantageous Market” in the main body of this letter, we believe the guidance presented is sufficient.

### **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?

*Response:* We agree that this is the appropriate approach, as it results in a measurement that represents the most likely price at which assets could be realized and liabilities extinguished. As noted in the main body of this letter under "Offsetting of Risk Positions," we believe this offsetting concept should be explicitly applied across all levels of the hierarchy. Other than this clarification, we do not believe the Board needs to consider other approaches.

### **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?

*Response:* Please refer to our comments under "Block Discounts" in the main body of this letter.

### **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?

*Response:* While we are aware that the Board has included a requirement to use multiple valuation techniques only where the information is available without undue cost or effort, we would ask for a further clarification. The application of multiple techniques may be possible for an individual transaction without such undue cost or effort, but to apply those multiple techniques to a portfolio of thousands of similar transactions would require substantial effort. Accordingly, we would ask that the Board specify that once the most appropriate technique is determined, that one technique may be applied to similar transactions.

### **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?

*Response:* We believe the guidance in Appendix B is sufficient to permit entities to estimate the fair value of restricted securities. In particular, we agree that restrictions that terminate within one year should also be considered, as set forth in Footnote 21.

### **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?

*Response:* Please refer to the section entitled “Disclosures” in the main body of this letter.

### **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.

*Response:* We believe the proposed effective date provides adequate time for implementation.

### **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?

*Response:* Please refer to the main body of this letter for the matters we view as most important to this process.

### **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.

*Response:* We would very much appreciate the opportunity to participate in the roundtable. Our representative would be Matthew Schroeder.