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To: Director - FASB

Subject: File Reference Proposed FSP FAS 157e

LETTER OF COMMENT NO. 8

I appreciate this opportunity to comment on FSP FAS 157-e and have included my comments in the following paragraphs. Because of the short time frame allowed for comments I will respond briefly, directly and respectfully.

The difficulties that preparers are encountering with SFAS 157 are not simply a matter of unusual economic events complicating the application of fair value accounting. The current FSP FAS 157-e and the previously issued FSP FAS 157-d were both necessitated by weaknesses inherent in SFAS 157. It is my firm belief that additional guidance will again be necessary in short order if the FASB continues with the fair value accounting model embodied in SFAS 157. The weaknesses of SFAS 157 are so deep and fundamental that I would encourage the FASB to undertake a complete re-writing of the standard, instead of issuing FSP FAS 157-e.

In the following paragraphs I have listed what I believe are the most damaging flaws of SFAS 157. Some sections are a reiteration of comment letters I have sent previously (and are noted as such), but they are expanded upon and placed in context with new information that should be useful to the reader.

Exit price premise of value: SFAS 157 makes a distinction between "entry price" (the price paid for an asset) and "exit price" (the price to sell an asset), and requires preparers of financial statements to utilize an exit price assumption when valuing an asset. An exit price premise of value effectively renders the concept of historical cost meaningless. While some may claim that the notion of exit price has theoretical appeal, from a practical perspective it offers very little of use to investors or management. What useful purpose does it serve to assume that a market price must be determined immediately for an asset just acquired? It is reminiscent of the TV commercial in which a gentleman bids for a unique work of art, and when his is declared the winning bid, immediately stands and states that he wants to sell it - to the amazement of all in attendance. Exit price also necessarily assumes that the company actually engaged in the transaction to acquire the asset is somehow removed from the universe of "market participants" that would buy the asset. What useful purpose does it serve to ignore the actual conditions and transaction by which the company acquired the asset? Due to its exit price focus, SFAS 157 results in an over-reliance on the theoretical perspective of "market participants" which is confusing, time-consuming and overly technical, and which provides little if any additional useful information to investors.

By focusing on an exit price premise of value, the FASB also opens the door to a highly suspect accounting treatment known as a "bargain purchase gain" which is included in SFAS 141R. Essentially, the idea of a bargain purchase gain allows a management team to claim that they are smarter than the market and acquired the assets at less than fair value (resulting in an immediate gain and an increase in equity). The exit price requirement allows management to value the assets based on their assumptions about an immediate sale of the assets just acquired — meaning that SFAS 141R establishes the concept of arbitrage (buy low in one market and sell high in another market) in the accounting literature. Events of the recent past would seem to indicate that such speculative accounting treatments are subject to quite some abuse.

Even more troublesome are the implications to the seller's Board of Directors when a buyer reports a bargain purchase gain. A Board of Directors has a fiduciary responsibility to maximize the value of the company's assets. By recording a bargain purchase gain a buyer necessarily brings into question whether the seller's Board of Directors actually met their fiduciary responsibility. If the buyer can identify market participants that would pay more for the acquired

assets, why couldn't the seller do the same? It would be difficult to argue with an attorney when she is armed with audited financial statements signed by an international accounting firm that states that the assets are worth more than what they were acquired for. This potential litigation liability comes as a result of the focus on exit price in SFAS 157.

Conflict with Going Concern and Legal Precedent: (based on my prior comment letter on Going Concern) SFAS 157 conflicts with long-established accounting theory related to "going concern" because it allows a company to re-value its liabilities to market value – below book value – and recognize a gain and a resulting increase in shareholders' equity.

If the FASB is moving toward financial statements that are strictly a theoretical construct, then the ability to re-value liabilities could make sense. But the concept of going concern is important because it removes financial statements from the theoretical realm and places them in the context of a real firm with real creditors and addresses a firm's ability to continue to function; an important part of that being the ability to repay its debts. At one level the FASB has created a contradiction within the standards themselves - management may re-value liabilities and imply a loss to creditors, yet not be required to disclose doubts about the company's ability to continue as a going concern. Outside of a purely theoretical framework, how could management not make a going concern disclosure if it recognizes that the value of its liabilities are worth less than what the firm is obligated to pay? When issuing financial statements without a going concern disclosure, are not management and the auditors making a statement that all liabilities are expected to be satisfied in full in the ordinary course of business? We may assume that "market participants" would buy and sell a company's debt obligations in a hypothetical secondary market at something other than face value. But the going concern concept places the responsibility squarely on management's shoulders to state their expectation whether these debts will be paid in full. If so the financial statements should reflect management's expectation, not the theoretical expectation of "market participants" in a hypothetical secondary market.

More damaging, in my view, is the contradiction that the FASB has created between accounting standards and long-established legal precedent. The idea of "absolute priority" is firmly established in bankruptcy law, which is properly considered in connection with the concept of going concern. According to Black's Law Dictionary, the absolute priority rule is:

"The rule that a confirmable reorganization plan must provide for full payment to a class of dissenting unsecured creditors before a junior class of claimants will be allowed to receive or retain anything under the plan."

So while legal precedent would dictate that debt-holders be made whole before equity-holders receive anything, SFAS 157 allows a loss to creditors with the result being a gain to equity. This could only happen in a theoretical sense. Long-standing legal precedent would preclude such a result in the real world.

At a minimum, the ability to revalue liabilities and recognize a gain should be precluded within the context of a firm that is expected to continue as a going concern. Real world experience would dictate that this cannot happen. Perhaps it would be useful to allow management to revalue liabilities when there is a doubt that the firm can continue as a going concern, but it should not under any circumstance result in a gain to equity holders. An offsetting reduction in the value of assets would seem to be most appropriate in that circumstance.

The conflict between SFAS 157 and the going concern concept is the thread that unravels the fabric of fair value accounting (as it is currently written). If management's expectations must, by definition, predominate in the measurement of liabilities, then why shouldn't management's expectations predominate in the measurement of assets? Many assets (particularly intangible assets) have utility and value only as a result of management's plans and stewardship. Without an effective management team implementing useful plans, the value of many assets would evaporate (as demonstrated by numerous bankrupt

companies). A sole reliance on the theoretical construct of "market participants" removes the critical element of value for many assets – management's expectations and plans; which are in every way as relevant to consider in valuation as are the theoretical expectations and plans of a hypothetical group of market participants.

Conflicts with the Movement to "Real-Time" or Shortened Closing of Corporate Books and Records: Many companies have worked diligently over the past decade to streamline accounting procedures in order to produce accurate financial results quickly, so investors can receive timely financial information. But SFAS 157 presents a conflict, because its requirements take a great deal of time to execute. A market, by definition, is a changeable thing. And changes within a market can be monumental as we have seen in the recent past. Market participants react to changes in the market, adjust their outlook, and change their valuation requirements; which causes movements in market prices. Minute-by-minute fluctuations in the stock market are a reflection of these facts. A valuation analyst cannot anticipate what changes may occur and how they might be realized, which is the reason that valuations for financial reporting purposes are prepared after the year-end (or quarter-end), not beforehand. An analyst must consider the changes that have occurred in a market and then consider how those changes relate to the asset in question. That is a simple matter for Level 1 assets, but guite another for Levels 2 and 3 assets. The valuation process involved for Levels 2 and 3 assets is highly subjective, requiring much judgment. Investors have a reasonable expectation that auditors will subject management's judgment to close scrutiny, all of which takes quite some time. The FASB must decide whether it is more important to have accurate financial results that can be produced in a timely fashion (which is where US businesses have been focused through their own desire to provide investors the information they need), or highly technical financial results that require a lengthy period of time to produce (which is the result of SFAS 157). An obvious improvement is allowing management's expectations and plans to be considered in the valuation process. Management's expectations and plans, unlike the theoretical perceptions of market participants, are known in advance and are likely to be a much more stable basis for valuation assumptions.

<u>Three-Tier Hierarchy</u>: (based on my prior comment letter on FSP FAS 157-d) It would appear that there is little controversy related to "Level 1" measurements, briefly defined as follows:

a. Level 1 - Quoted price, identical asset, active market.

"Level 2" measurements encompass a wide range of calculations and introduce an element of subjectivity, which FSP FAS 157-d attempts to address. "Level 2" measurements are briefly defined as follows:

- a. Level 2 Quoted price, similar asset, active market.
- b. Level 2 Quoted price, identical or similar asset, inactive market.
- c. Level 2 Inputs other than quoted prices that are observable.
- d. Level 2 Inputs that are derived from or supported by observable market data.

"Level 3" measurements are calculated with the use of unobservable inputs.

Through the Fair Value Hierarchy detailed in SFAS 157 (and summarized above), the FASB implicitly establishes Level 1 measurements as being more reliable than Level 2 measurements, which in turn are more reliable than Level 3 measurements. This concept of reliability is reinforced by the disclosure requirements of SFAS 157, which establish more detailed disclosures for Level 3 assets/liabilities than for Level 1 and Level 2 assets/liabilities.

FSP FAS 157-d, however, highlights that Level 2 measurements are affected by a great deal of subjectivity, particularly when markets are inactive. Likewise, business valuation analysts have long struggled with the concept of comparability, or similarity, when valuing a security or business due to the subjectivity involved. Thus, for two types of Level 2 measurements — a)Quoted price, similar asset, active market and b)Quoted price, identical or similar asset, inactive market — it is

not proven, nor would it appear to be widely accepted, that they are likely to produce demonstrably more reliable results than are Level 3 measurements.

It is important for the FASB to acknowledge that there is no effective distinction in reliability between Level 2 and Level 3 measurements. Everything below Level 1 measurements are most properly considered a "management estimate" regardless of the technique used to estimate value. A two-tier hierarchy – Level 1 and all else – would be the most accurate representation for financial reporting purposes, and would seem to address some of the difficulties in applying SFAS 157.

<u>Conclusion</u>: The flaws in SFAS 157 are not easily fixed, and additional explanatory guidance will serve no useful purpose for management teams or investors. Additional "patches" will again soon be required if the fair value accounting model set forth in SFAS 157 remains in effect. A complete re-writing of SFAS 157 is required to correct its flaws.

Thank you for considering this letter. I appreciate the opportunity comment on FSP FAS 157-e.

Sincerely,

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