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DUFF & PHELPS



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LETTER OF COMMENT NO. 18

Mr. Russell G. Golden
Director of Technical Application and
Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference - Proposed FSP FAS 157-c

Duff & Phelps appreciates the opportunity to provide comments on Proposed FSP FAS 157-c. We would be pleased to further discuss our comments with the Board and staff. Please direct any questions to Paul Barnes in our Philadelphia office at (215) 430-6025.

Sincerely,

/s/ Paul F. Barnes
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Global Leader – Valuation Advisory Services

Proposed Guidance on the Fair Value Measurement of Liabilities under Statement No. 157, *Fair Value Measurements*

We agree that the proposed FSP provides guidance that would simplify fair value measurements of certain financial liabilities; however, this is accomplished at the expense of the conceptual integrity of the Statement 157 framework. Since the scope of the proposed FSP applies to all liabilities that would be measured at fair value under Statement 157, the overall impact of the guidance in the FSP might be to rescind the exit price and principal market concepts for liabilities that were articulated in that Statement.

Proposed Measurement Guidance for Instruments Traded in Active Markets

Paragraph 6 of the proposed FSP requires that the quoted price for the “identical liability” (unadjusted) in an active market be used as the fair value measurement for both (a) the obligor of the liability and (b) the asset holder.¹ We believe that using the price for the asset side of the instrument traded in an active market in the measurement of the respective liability would have been the ultimate conclusion of applying Statement 157, as issued, without employing the additional guidance above (the liability itself is not traded, as paragraph 6 presupposes).

An alternative explanation with the same end result might be to recognize that the respective asset and liability sides of the instrument have the same economic characteristics, including risk/nonperformance risk; however, the principal markets for the asset and the liability are different. Since it is unlikely that observable inputs from the principal market for the liability would be available or sufficiently relevant, inputs from other markets (for example, the active market for the asset) would be used in the fair value measurement of the liability, on the grounds of the economic similarity of the two, and subject to further adjustment, as appropriate.²

The only difference in the end result between this approach and the approach formulated in paragraph 6 of the FSP would be that, under the suggested alternative explanation, the liability measurement might not unequivocally be perceived to be a Level 1 measurement, because technically, *identical liabilities* are not traded in active markets. In contrast, it seems that under the FSP, the fair value measurement of the liability would be classified within Level 1 of the fair value hierarchy.

¹ We observe that the guidance in paragraph 6 would apply primarily, if not exclusively, to financial liabilities.

² It seems unlikely that there would be any adjustments in the case of most financial liabilities. For example, although it may appear that the transferee of the liability would be “saving” on issuance costs and would therefore, in theory, be willing to pay an amount higher than the market price for the corresponding asset, such “savings” in fact represent transaction costs, and should not affect the fair value measurement of the liability.

Proposed Guidance for Liability Measurements in the Absence of Active Markets

Based on the background provided in the FSP, it appears that some of the concerns that have prompted the guidance in paragraph 7 of the document include the following: 1) lack of actual transfers of liabilities, and 2) the notion that the transferee of the liability is deemed to have the same nonperformance risk as the transferor (the reporting entity).

▪ Lack of Actual Transfers of Liabilities

Because in practice, *liability transfers typically do not occur*, paragraph 7 instead focuses on the amount to be received to issue (incur) a liability, which could be observable. Many find the fact that the fair value measurement of a liability embodies a “hypothetical measurement attribute” problematic; however, we observe that actual transfers of a number of intangible assets likewise do not occur in the market; yet, fair value measurements of such intangibles are routinely performed.

Allowing the use of an entry price in the measurement of a liability, in lieu of an exit price in a hypothetical transfer, raises the issue about similarly allowing the use of an entry price for an asset (the price that would be paid for the asset), *particularly in the case in which the asset is not traded and/or has a related non-traded liability*. That is, for non-traded instruments, a reporting entity may find it just as challenging to measure fair value to the counterparty (asset holder) of such a liability, as the issue of a hypothetical measurement “based on a transfer notion that would not occur in the marketplace” holds equally for both the liability and asset sides of certain securities. In general, it would seem logical that the asset and liability side of an instrument would equal; however, that ignores the principal market notion altogether. As illustrated by Example 7 in Statement 157, the fair value of an instrument could be different in different principal markets.

▪ Nonperformance Risk

With respect to explaining the inclusion and effect of nonperformance risk on the fair value measurement of a liability, paragraph 7 of the FSP seems to take a “shortcut” by stating that the reporting entity acts as the issuer, rather than as the transferor of the liability, contrary to the exit price and principal market notions in Statement 157.

An alternative explanation with the same end result might be provided by analyzing the requirements of Statement 157, as issued. Statement 157 requires that the fair value of a liability reflect the nonperformance risk relating to that liability; in our view, this entails treating nonperformance risk as an *attribute of the liability*, and therefore considering such risk in the fair value measurement.³ One aspect of nonperformance risk relating to the liability may stem from the entity: in particular, Statement 157 requires *consideration of the effect* of the credit risk of the entity on the fair value of the liability. In those cases in which the reporting entity’s credit risk

³ Paragraph 6 of Statement 157 states that “[a] fair value measurement...should consider attributes specific to the asset or liability.”

does affect the fair value of the liability, as might be the case in a situation in which the liability has no internal or external credit enhancements, this aspect of nonperformance risk also becomes (or is treated as) an *attribute of the liability*.

From that perspective, the notion that the nonperformance risk of the liability is the same before and after the (hypothetical) transfer is more of a reflection of the *attributes of the liability*, rather than a reflection of a hypothetical assumption that the transferee of the liability has the same nonperformance risk as the transferor. We also understand the latter to be an assumption that was intended to simplify, rather than complicate the fair value measurement of the liability.

Further, while the language in paragraph 7 of the FSP seems to describe a financial liability⁴, because of the broad scope of the document, the proposed guidance could be interpreted as allowing the use of an entry price for liabilities in general; for a nonfinancial liability, that could be either the amount incurred or received by the reporting entity. Meanwhile, the market in which a liability is incurred (or issued) likely would be different from the one in which it would be transferred; therefore, entry and exit prices might not be the same. Therefore, the guidance in paragraph 7 of the FSP might potentially lead to the non-recognition, in some cases, of the profit element related to a nonfinancial liability as part of the fair value measurement.

In conclusion, while the FSP, as proposed, may simplify the application of Statement 157 in certain circumstances, it does so at the expense of the integrity of the fair value measurement framework in that Statement, and therefore might increase the challenge of understanding and applying Statement 157 broadly. Assuming that the Board continues to be firm on its conclusions reached in Statement 157, we observe that any practical expedient - whereby either an entry price or other amount is used in the fair value measurement of a liability - should be clearly labeled as an exception, given the framework in that Statement. Further, such exception may need to be limited to certain types of liabilities, for example, financial liabilities, and may need to consider "the asset side" of such liabilities, where appropriate.

Other Areas for Consideration Related to the Fair Value Measurement of Liabilities

In general, we believe that further guidance would be beneficial with respect to the fair value measurements of liabilities within the Statement 157 framework. We provide a few examples below:

Liabilities and Valuation Premise

A clarification may be helpful as to whether, in the case of a *non-financial liability*, the transferee has *the same assets in place, including know-how, as the transferor (the reporting entity)*, otherwise, the reporting entity might have to pay more to a market

⁴ Reference is made to a liability *issued* and proceeds received by the reporting entity.

participant to assume and fulfill the liability (for example, either due to a learning curve that would have to occur, or perhaps the market participant may not have key related assets in-house); at times this might have a significant impact on the fair value measurement.

In essence, this raises the question about the applicability of a notion similar to *valuation premise* for liabilities. Would a presumption that the transferee has the same assets in place that would be required in fulfilling the liability as the reporting entity somehow contradict the notion in both CON 7 and Statement 157 that the reporting entity's advantages/disadvantages should not be incorporated in the fair value measurement?⁵ On the other hand, if nonperformance risk is also a function of the assets currently available to fulfill or extinguish the liability at the reporting entity, then perhaps the transferee could be presumed to have the requisite resources automatically. This type of clarification as to the *unit of valuation for liabilities* might also shed light on who the market participant is for a liability transfer, e.g. if it is someone like the reporting entity or different.

We also observe that a notion similar to an "in-use premise" for liabilities may explain why a substantial number of liabilities are *not transferred standalone* but rather as part of a group of assets or a business, as may be the case, for example, with asset retirement obligations. In other words, the applicability of "premise" may be one explanation as to the lack of actual transfers of liabilities on a standalone basis.

Liabilities and Restrictions on Transfer

We observe that in the case of assets, a restriction on transfer that is deemed to be an attribute of the asset (and not the holder) would be reflected in the fair value measurement. The notion of restrictions may need to be further explored in the area of liabilities. Would it be appropriate to reflect a restriction on the transfer of a liability in the fair value measurement, and if so, in what circumstances? In a related issue, if a liability cannot be legally transferred to another party, such that the reporting entity's (transferor's) obligation is extinguished entirely, should that restriction be "assumed away" or should it be incorporated in the fair value measurement, and how?

Liabilities and Credit Risk of the Reporting Entity upon Initial Recognition

Statement 157 requires that in a fair value measurement, the reporting entity consider the effect of its credit risk on the nonperformance risk of the liability. Applying this guidance in the context of an exit price might occasionally lead to some counterintuitive results upon *initial recognition* of a liability. For example, in a business combination in

⁵ Paragraph C40 of Statement 157 states: "[c]onceptually, a fair value measurement provides a market benchmark to use as a basis for assessing the reporting entity's advantages (or disadvantages) in performance or settlement relative to the market. Specifically, when a liability is measured at fair value, the relative efficiency of the reporting entity in settling the liability using its own internal resources appears in earnings over the course of its settlement, not before".

which the reporting entity assumes a liability with no internal or external credit enhancements, and the reporting entity's credit standing is higher than that of the target, the result might lead to the inclusion of a credit enhancement in the fair value of the liability upon its initial recognition. In other words, because the reporting entity's credit standing is higher than that of the target, the fair value of the liability would increase.⁶ Therefore, because of a credit enhancement which may be entity-specific, the reporting entity is, in effect, assuming a larger liability.⁷

We recognize that there is other guidance within GAAP (specifically, in the EITF literature) that appears consistent with the above. Nonetheless, the issue might warrant further analysis.

⁶ In this case, because of the nature of the liability, the credit standing of the holder is a component of the nonperformance risk related to the liability; i.e., it becomes (it is treated as) an attribute of the liability. The question is whether the "holder" here should be the acquirer, the target, or the combined entity.

⁷ In a business combination, the effect of this would be to increase goodwill.