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DUFF&PHELPS

March 31, 2009

LETTER OF COMMENT NO. 380

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

File Reference: Proposed FSP 157-e

Dear Mr. Golden:

Duff & Phelps Corporation (NYSE: DUF) appreciates the opportunity to provide comments on the Proposed FASB Staff Position FAS No. 157-e, Determining Whether a Market Is Not Active and a Transaction Is Not Distressed.

As a leading global independent financial advisory firm, a key advisor to clients struggling with global valuation issues and a developer of pragmatic solutions for applying fair value techniques, we provide a unique perspective in the practical application of valuation related principles both under United States Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS). Working with numerous clients we have experience validating the valuation assessments of thousands of illiquid securities on a regular basis. We also see how SFAS 157 has been applied by numerous companies and interpreted by independent accountants.

We would be pleased to further discuss our comments with the Board and staff. Please direct any questions to David Larsen at (415) 693-5330.

Sincerely,

David L. Larsen, CPA Managing Director

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Background

We have been actively involved in assisting numerous clients with implementation issues raised by SFAS 157 and validating the fair value estimates of thousands of illiquid securities. We have been a frequent participant in the debate that has raged around fair value accounting in general and applying SFAS 157 in particular.

We agree with the December 2008 SEC mark-to-market study which indicates that improvement is needed in applying judgment, where appropriate, with the objective of arriving at a measurement that is most representative of fair value in the circumstances.

Based on the items noted below and our reading of the proposed FSP, we believe that modification is required to ensure that the objective of SFAS 157 is met (obtaining in practice a consistent application of fair value, as defined).

Our experience demonstrates the following key points:

- A. SFAS No. 157 is a principles-based statement requiring the use of judgment in its application. Historically, preparers of financial statements and auditors, especially with the advent of regulation by the PCAOB, have operated in a rules based framework. The inherent conflict between a rules based framework and the application of principles based judgment has caused inconsistent determination of fair value estimates. One fact which demonstrates this conflict is the commonly held public misconception that SFAS 157 requires "fire sale prices."
- B. The "Exit Market" premise of SFAS 157 has evolved in practice in such a way that it is interpreted as a "bid price" or a "last observable transaction price". In contrast, excerpts from paragraphs C25 and C26 of SFAS 157 can be paraphrased as follows: The *hypothetical* transaction price at the measurement date is an *orderly* price ... "not a forced transaction (for example, if the seller is experiencing financial difficulty)." (emphasis added)

In addition, paragraph 31 of SFAS 157 states "the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls." Application of SFAS 157 has not uniformly followed *orderly* transaction principles.

C. It is our understanding the problems identified in B above should have been addressed by FSP FAS 157-3. However, because of the interpretation used by many that virtually no transactions meet the definition of a "forced" or distressed transaction, observable transaction pricing has continued to trump the use of unobservable inputs. Even when unobservable inputs are used, discount rates based on last observable transaction pricing have resulted in fair value estimates that are similar to the price of the last observable transaction.

D. SFAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an *orderly* transaction between market participants at the measurement date. The concept of "orderly" transaction is not uniformly applied. Some believe virtually all transactions are inherently "orderly" resulting in the view that the most recent observable transaction price or implied yields from current or most recent observable transactions represent the best estimate of fair value.

Others believe the concept of "orderly" allows for the exercise of judgment, especially in a dislocated and less liquid market such as the one found in the second half of 2008 through today. Current market conditions must be taken into account, but judgment is required to determine the extent to which these conditions impact an "orderly" transaction and the estimate of fair value at the measurement date.

E. The concept of liquidity risk premiums is often overemphasized in the current dislocated market. The term "Liquidity risk premium" is often used to attempt to describe the difference between contractual cash flows and observable transaction data. However the overreaching use of the term "liquidity" unduly simplifies the impact of various forces in the current market environment.

Therefore, the use of discount rates, implied from observable transaction data, used to estimate fair value may be flawed. Typically, an investor considers a risk free rate of return plus a realistic risk premium, plus a marketability premium (the actual liquidity impact), if relevant, in determining the required return. If cash flows are not adjusted for expected losses, then an additional expected loss premium would be applied to the discount rate for the contractual cash flows.

Illustrative Example

This is best explained through a relatively simplistic example. Assume a privately issued bond with a par value of 100, a stated interest rate of 12 percent, with a term of 5 years, issued at the end of 2006. However, because the bond is considered a risky bond, market participants recognize that its "expected cash flows" are less than the promised cash flows.

To illustrate, assume for purposes of this example that the market participant expects to receive interest for the first four years but believes that there is some probability of financial loss in the fifth year, such that the expected final payment will be only \$99.80 instead of the contractual \$112 in year five. Therefore, the bond will sell for a price equivalent to par of \$100 consistent with discounting the expected cash flows at the market participants' required rate of return of 10 percent. This required rate of return is made up of, for example, 3.5 percent risk free rate, plus a 5 percent risk premium, plus a 1.5 percent premium for the lack of marketability associated with a private placement. (Note: In this example, the effect on price of expected losses is incorporated in the cash flows. Therefore no expected loss factor is included in the discount rate.)

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Interest payments of \$12 each were received in 2007 and 2008. Contractual cash flows for the remainder of the term are \$12, \$12, and \$112. However, because of economic difficulties, the preparer determines that the expected cash flows for the remainder of the term will be \$12 in 2009; \$0 in 2010 (default on the payment of interest) and \$80 in 2011 (no interest will be received and the principal will only be partially recovered).

To estimate fair value at a measurement date in 2009, further assume that a market participant in the current dislocated market would require a return of 20% for an orderly transaction (risk free rate of 3.5 percent plus an expanded risk premium of 12 percent, plus an expanded marketability premium of 4.5 percent). (Again, the effect on price of expected losses is incorporated in the cash flows not in the discount rate). The expected cash flows, discounted by 20% would result in a price of \$56.

Now assume that another holder of a similar bond, driven by its own specific circumstances decided to sell their bond at \$20 (indicating a discount rate of 81 percent). Current practice in applying SFAS 157 would indicate a bias towards the \$20 price as the estimate of fair value.

Many have attempted to identify similar extreme price differences of the indicated \$20 to \$56 in this example as representing a liquidity risk premium. Such an argument is essentially using the term liquidity risk premium as a plug number to reconcile to an observed price that may not have been established in an orderly transaction.

The estimated price of \$56 can rationally be explained as a hypothetical orderly transaction price based on reasonable estimates of expected cash flows, discounted using the observable risk free rate, plus estimated current market risk and marketability premiums. The difference between the \$56 and \$20 is best explained as either a seller experiencing financial difficulties or as the impact of a dislocated market (e.g. an extreme supply/demand imbalance—which could be an indicator of a transaction that is not orderly), not as a liquidity premium.

Just as it would be inappropriate to use a yield of 12 percent given current market conditions, it would not be appropriate to use an 81 percent discount rate to represent an *orderly* transaction. In markets that are not active, the determination of expected cash flows and appropriate discount rates likely requires rigorous analysis utilizing informed judgment.

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Solutions and suggestions related to the observations and concerns noted above are included in our responses to your specific questions as follows:

Responses to Specific Questions

1. Is the proposed effective date of interim and annual periods ending after March 15, 2009, operational?

For preparers that have been exercising judgment in determining fair value estimates, the proposed effective date is operational as the proposed guidance would not be expected to result in any significant change. For preparers who have been utilizing "last transaction" pricing additional effort, potentially significant effort, may be required to analyze and estimate fair value using unobservable inputs. For such preparers, the effective date of application may be aggressive.

The FSP essentially further clarifies the position that "last transaction" or observable prices may not be adequate for determining a fair value estimate. The determination of whether a transaction is or is not distressed should lead to an increased use of cash flow models. Such models in most cases will be very complex, will need to be robustly determined, thoroughly validated, and as Chairman Herz stated in his House Subcommittee Testimony on March 12, 2009, may require the assistance of a third party advisor.

2. Will this proposed FSP meet the project's objective to improve financial reporting by addressing fair value measurement application issues identified by constituents related to determining whether a market is not active and a transaction is not distressed? Do you believe the amendments to Statement 157 in this proposed FSP are necessary, or do you believe the current requirements in Statement 157 should be retained?

Further clarifications to SFAS 157 are necessary as demonstrated by the inconsistent application in practice of SFAS 157 principles. In general, the proposed FSP should provide improvements in the application of fair value concepts. The FSP clarifies how to determine when a market is not active by identifying seven indicative factors. Some have questioned whether the factors apply to markets in general or are limited to markets for specific assets.

The FSP needs to be enhanced to clarify the impact of pricing information in markets that are not active and to clarify the determination of a hypothetical orderly transaction price at the measurement date under current market conditions. As noted in E above, an *orderly* transaction price may differ substantially from an observable transaction price.

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The FSP provides the presumption that all transactions in a market that is not active are distressed unless it can be demonstrated, consistent with the International Accounting Standards Board Expert Advisory Panel paper, that there was usual and customary marketing time to execute the transaction and that there were multiple bidders. Since the FSP does not require a preparer to obtain information that a transaction is not distressed, it is likely that most transactions in a market that is not active will be deemed distressed.

We recommend that the FSP be revised to eliminate Step 2. Both observable and unobservable inputs may, depending on the specific circumstances, be appropriately utilized in determining fair value in markets which are not active.

Preparers should determine the relative significance of the factors identified in step 1 which identify a market as not being active. The relative significance of factors indicating a market that is not active would impact the weighting of observable and unobservable inputs.

For example, in situations in which transaction frequency has significantly decreased from historical averages, transaction dollar volume has significantly decreased from historical averages, and bid/ask spreads have widened compared to historical markets, greater weight would be placed on unobservable inputs. In situations where transaction frequency and dollar volume are closer to historical averages and bid/ask spreads are in a more normalized range, greater weight would be placed on observable inputs.

While such an approach is clearly judgmental and may require the assistance of third party advisors in certain circumstances, it would result in fair value estimates that were better calibrated to the concept of an *orderly* hypothetical transaction under current market conditions.

3. Do you believe the proposed two-step model for determining whether a market is not active and a transaction is not distressed is understandable and operational? If not, please suggest alternative ways of identifying inactive markets and distressed transactions.

As noted above, we believe that the proposed two-step model should be eliminated. All relevant inputs, both observable and unobservable should be considered for use in estimating fair value. The inputs that are ultimately used in estimating fair value would be a matter of judgment. Judgment would be impacted by the relative significance of the factors identified in paragraph 11.

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4. Are the factors listed in paragraph 11 of the FSP that indicate that a market is not active appropriate? Please provide any other factors that indicate that a market is not active.

The factors listed in paragraph 11 of the FSP are appropriate for determining when a market is not active, but, as stated, may not be all inclusive.

In addition to providing an indication of a market that is not active, the FSP should clearly identify the factors listed in paragraph 11 as characteristics of transactions that may not be orderly. The greater the relative significance of the factors identified in paragraph 11, the less reliable an observable transaction price may be in the estimation of fair value.

5. What costs do you expect to incur if the Board were to issue this proposed FSP in its current form as a final FSP? How could the Board further reduce the costs of applying the requirements of the FSP without reducing the benefits?

If the previous application of SFAS 157 included the appropriate use of judgment including the use of unobservable inputs we do not expect significant additional costs to be borne by financial statement preparers. However, to the extent that preparers have been utilizing only observable pricing, additional costs for creating and validating relevant models may be incurred.

Unintended Consequences

We understand the Board has added the question of estimating fair value for investors in alternative investments to its agenda. The proposed FSP as currently drafted may appropriately eliminate or significantly reduce the use of secondary market transactions as a potential determinant of fair value because the secondary market would likely meet the definition of a market that is not active.

However, some may interpret paragraph 15 of the proposed FSP as requiring the use of an income approach. Alternative Investment investors would incur significant cost and effort to create cash flow models for each of their underlying limited partnership interests. Until the Board determines the applicability of using Net Asset Value in estimating the fair value of limited partnership interests, some guidance should be given to provide a moratorium for limited partner investors being required to create cash flow models that do not currently exist.

Further, the scope of the proposed FSP is limited to financial assets. By implication the FSP applies to *all* financial assets, but not liabilities or non-financial assets. Such a limitation may be problematic for valuing derivatives which can alternate between assets and liabilities.

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Specific Comments to Proposed FSP FAS No. 157-e Appendix: Amendments to Statement 157 and FSP 157-3.

We offer the following specific comments [comments included in bold] and suggested changes (underlined) to the proposed amendments to SFAS No. 157:

Paragraph 29A:

[Step 2 should be eliminated as noted above. New wording should be added to incorporate the concept of appropriately weighting inputs to ensure that an orderly hypothetical transaction price is determined as of the measurement date.]

[The scope of the FSP appears to cover only financial assets. The new paragraph 29A appears to apply to all assets and liabilities]

Paragraph A32D: ... Entity A uses an estimate of the expected cash flows...

Paragraph A32E:

- ... For this collateralized debt obligation security, the available information used to estimate an appropriate rate of return included:
- (1) Risk-free rate based on the rate of return on government debt securities
- (2) Risk Premium (credit spread) estimated from trading prices of similar actively traded securities in the current market, including new issuances if any; or estimated from historical actively traded similar securities adjusted for the expected impact of current market conditions. [Note: there typically are no current issuances of securities for which the market has become inactive]
- (3) Reasonable assumptions regarding nonperformance risk (for example, default risk and collateral value risk, to the extent not included in the estimation of "expected cash flows") and a marketability discount that willing buyers and willing sellers would consider in pricing the asset in an orderly transaction based on current market conditions...

[Please see Background section E above. We suggest deleting the term "liquidity" and replacing it with the component parts of the expected return (risk free rate; risk premium; marketability discount). The expected loss premium is effectively embedded in the concept of expected cash flows.

Alternatively, an expected loss premium could be used but cash flows would then need to be contractual cash flows not expected cash flows. The concept of liquidity has come to include a number of elements which may or may not be due to liquidity and may or may not reflect an orderly transaction. Therefore, we believe that it is more

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appropriate to focus on what a market participant would require as a return given current market conditions.]

Paragraph A32F:

Entity A <u>calibrates the</u> range of possible rates of return <u>at investment origination to the rates of return required for orderly transactions given current market conditions.</u>

Based on this calibration it is determined that possible rates of return range from 7 percent (based on an estimated rate of return for the collateralized debt obligation in a hypothetical orderly market at the measurement date derived by reviewing required rates of return for securities trading in relevant active markets) to 15 percent (based on bid-level yields implied by the difference between the contractual cash flow amount and the expected cash flow estimate discounted using a reasonable assumption of a market participants assessment of the risk free rate, plus current market risk and marketability premiums).

Because 7 percent is not a rate that willing buyers would accept for this security given that its market is not active and 15 percent is not a rate that willing sellers would accept, Entity A uses judgment to determine the appropriate rate. One possible choice would be 8.5 percent calculated as the hypothetical orderly market rate of 7 percent plus a premium for lack of marketability of 1.5% with the objective of replicating an orderly transaction under the current market conditions. This result would put more weight on the data drawn from functioning orderly markets. Another possible choice would be to use the midpoint or 11 percent and thus put equal weight on the results from orderly markets and observable transactions in the current market that is not active. (see paragraph 31). The weighting of the data points used would require judgment and would depend on the relative significance of the factors indicating that the market is not active.