



Ernst & Young LLP
5 Times Square
New York, NY 10036
Tel: 212 773 3000
www.ey.com



LETTER OF COMMENT NO. 12

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

1 June 2009

Proposed FASB Staff Position No. FAS 157-f, "Measuring Liabilities under FASB Statement No. 157"

Dear Mr. Golden:

We are pleased to comment on the proposed Financial Accounting Standards Board (FASB or the Board) Staff Position No. FAS 157-f, "Measuring Liabilities under FASB Statement No. 157" (the proposed FSP). We commend the Board for attempting to provide additional clarity regarding the measurement of liabilities at fair value in accordance with the requirements of FASB Statement No. 157, *Fair Value Measurements* (Statement 157). We support the Board's efforts to provide practical guidance intended to improve consistency in the application of the principles of Statement 157 to the measurement of liabilities. Subject to the comments discussed below, Ernst & Young supports issuing the proposed FSP in final form.

Measurement Objective

The proposed FSP would amend Statement 157 to provide guidance on the various valuation approaches to be used in estimating the fair value of a liability in situations in which a quoted price in an active market for the identical liability does not exist. As it pertains specifically to the market approach, paragraph 9d of the proposed FSP describes "a technique that is based on the amount the reporting entity would receive if the reporting entity was to transfer or enter into the identical liability at the measurement date." We recommend that the Board clarify that a similar basis would be used in estimating the fair value a liability regardless of the valuation approach used. That is, while an income approach may utilize a present value technique to discount expected future cash flows associated with a liability, the intention of the measurement is also to quantify the amount that would be associated with a transfer of the liability at the measurement date (i.e., an exchange price notion). The objective of a market approach is the same, but as discussed in Statement 157, uses prices and other relevant information generated by market transactions involving identical or comparable liabilities. Additionally, we believe the above sentence from paragraph 9d (paragraph 15B(d) of the proposed amendment to Statement 157) should be corrected to clarify that the reporting entity would make a payment upon the transfer of a liability. Any amount to be received by the reporting entity would be limited to the consideration of a "reentry" transaction (i.e., a transaction to enter into the identical liability as the measurement date).

The guidance in paragraph 9d appears to be predicated on the presumption that a reentry price will always equal the exit price for a liability. While this might be the case for certain liabilities, there are a number of reasons why a reentry price may not equal the exit price for a particular liability. For example, reentry and exit price could differ in situations in which an entity would transfer the liability in a different market from that in which the obligation was incurred. This could be the case for dealers who enter into transactions (including liability transactions) in the retail market, but would exit in the inter-dealer market. In addition, the existence of bid-ask spreads in the market in which the liability (or conversely the asset held by the counterparty to the obligation) trades could result in a difference between a reentry price and an exit price. Appendix A to this letter includes an example from our previous comment letter on proposed FSP 157-c, dated 21 February 2008, that highlights the implications of bid-ask spreads on the use of reentry versus transfer prices when estimating the fair value of a derivative liability.

In the final FSP, we recommend that the FASB clarify that the objective of a fair value measurement for a liability remains the price that would be paid to transfer the obligation (i.e., an exit price). Therefore, while consideration of a reentry price may be appropriate, a reporting entity should assess the exit market and the characteristics of market participants in the exit market when estimating the fair value of its liabilities. Providing this clarification would be consistent with the guidance in paragraph 12 of the proposed FSP, which notes, "an entity shall ensure that the fair value measurement is consistent with the principles [of Statement 157]", including "the principal market and unit of account requirements of [the] Statement."

Contractual Restrictions on Transfer of Liabilities

Paragraph 11 of the proposed FSP states that when estimating the fair value of a liability "an entity shall not include a separate input or adjustments to other inputs relating to the existence of a contractual restriction that prevents the transfer of the liability." As proposed, this guidance applies to both initial and subsequent fair value measurements. The basis for this conclusion in the proposed FSP appears to stem from the view that the effect of any restrictions on transferability would have been appropriately captured in the transaction price for the instrument as both parties to the transaction were fully knowledgeable of all such restrictions at the time the transaction was executed. While the implications of this view on the initial measurement of a liability are clear, the link between this view and the guidance regarding the subsequent fair value measurement of a liability is less clear and has resulted in confusion among constituents.

For example, some constituents have noted that any contractual restrictions associated with the sale of an asset would also be captured in the transaction price, but Statement 157 does not similarly prohibit adjustments related to the effect of these restrictions on subsequent fair value measurements of the asset. Instead, Statement 157 notes that the fair value measurement of a restricted asset should consider the effect of the restriction if market participants would consider it. Additionally, paragraph 10c of the proposed FSP notes that the inclusion of the effect of a restriction on the price of an asset is one of the circumstances that may warrant an adjustment when using an asset price to estimate the fair value of a corresponding liability. As such, when considering an instrument that has restrictions on both its sale (as an asset) and transfer (as a liability), the proposed guidance would seem to imply that the value of the asset and liability are identical at initial recognition (i.e., both are measured using the transaction price), but would diverge on subsequent

measurement when any effect of the restriction on the price of the asset would be adjusted in estimating the fair value of the liability. If that is the intent of the guidance in the proposed FSP, we question this conclusion. In our view, the value of the asset and related liability should continue to equal upon subsequent measurements. The need to make an adjustment in valuing the restricted asset stems from the nature of the information that is likely available to estimate the fair value of the asset. In many instances, lacking observable data regarding the value of an asset that is similarly restricted, a reporting entity would look to the price of a similar asset that is not restricted. The price of this non-restricted asset would then need to be adjusted to reflect the restriction associated with the asset actually being measured. However, if information was available regarding the price of a similarly restricted asset (e.g., through the issuance of similarly restricted debt), no adjustment to this price would be necessary. In the example described above, it would seem to us that the fair value of a liability associated with a restricted asset should equal the fair value of that asset upon subsequent measurement (as it would at issuance), not the value of an unrestricted asset.

In order to address any confusion surrounding this issue, we strongly recommend that the FASB revise or, at a minimum, more clearly articulate the rationale for its conclusions in the proposed FSP that (i) the price of a restricted asset needs to be adjusted when used in measuring the fair value of its corresponding liability, and (ii) a separate input or adjustment to other inputs to reflect the effect of contractual restrictions is not necessary when measuring the fair value of a liability at subsequent measurement dates. Items to be discussed might include (i) whether the Board believes the effect of a restriction on the fair value of an instrument remains constant or instead can change over time depending on market conditions, and (ii) whether the Board believes there is a fundamental difference between the effect of restrictions on the fair value of assets versus liabilities, and if so, why.

Illustrative Examples

The proposed FSP acknowledges that constituents are concerned about the lack of observable market information available to determine the fair value of many liabilities. This lack of market information poses a challenge for constituents attempting to estimate the fair value of their liabilities, particularly with respect to the assumptions of market participants regarding required risk premiums. For example, estimating the risk premium associated with the transfer of long-dated liabilities, such as an asset retirement obligation (ARO), can be very subjective given the lack of market data from which to ascertain market participants' perspective on the premium they would require to assume these highly uncertain future cash outflows.

The proposed FSP provides an illustrative example that addresses considerations when estimating the fair value of an ARO on initial recognition. While the example includes a list of inputs market participants would likely consider in estimating the fair value of an ARO (e.g., probability-weighted estimate of labor costs, overhead costs, profit margin, expected effect of inflation, risk premium, and nonperformance risk), the example is not especially helpful as it is essentially duplicates the illustrative example that currently exists in FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (Statement 143). Like the example provided in Statement 143, the example in the proposed FSP includes an explicit adjustment to the estimated cash flows of 5%, representing the market-risk premium a contractor would typically demand and receive for bearing the uncertainty inherent in locking in a price at the measurement date for a project that will not occur for 10 years.

However, the example does not indicate how the 5% risk premium was determined, nor does it provide any additional guidance or considerations regarding how reporting entities would determine this adjustment in practice.

While the concept of incorporating a risk premium into the fair value measurement of a liability is not new, the adoption of Statement 157 has resulted in constituents seeking additional guidance regarding how such a risk adjustment can be determined. Under the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, a risk adjustment was included in the measurement only if the amount of the adjustment was identifiable, measurable, and significant. As such, explicit risk premiums were typically excluded from the fair value measurement of AROs, as the above conditions were often not met. However, the clarification in Statement 157 that a fair value measurement should include a risk adjustment if a market participant would include one in pricing the asset or liability, even if the adjustment is difficult to determine, requires that constituents reconsider the need to incorporate a risk premium when estimating the fair value of liabilities with uncertain cash flows, such as AROs. Accordingly, we believe some discussion of the considerations in estimating the risk premium associated with the ARO in the illustrative example is warranted. Without further clarification, many constituents will likely determine that the incorporation of an explicit assumption regarding the risk premium on an ARO is not possible as discussed in paragraph A20 of Statement 143.

Liabilities measured at fair value

The issue regarding the appropriate measurement objective to be used when recognizing liabilities (both financial and nonfinancial in nature) continues to be an area of focus for standard setters, preparers, investors, auditors and regulators. In its December 2008 study on mark-to-market accounting as mandated by the Emergency Economic Stabilization Act, the Securities and Exchange Commission (SEC) staff noted that, in its view, "the current guidance regarding the measurement of liabilities at fair value has the potential to result in confusion in the marketplace and additional consideration in this area is warranted." More recently, this topic was the subject of much debate during a series of discussions held by the Financial Crisis Advisory Group (FCAG). While much of the early debate focused on whether nonperformance risk should be considered when estimating the fair value of a liability, the debate has subsequently shifted (appropriately so, in our view) to a discussion on whether and when fair value should be the measurement objective for liabilities.

We support the recent decision by the FASB and the IASB to undertake a joint project, on an accelerated basis, to develop a globally accepted replacement of the accounting requirements for financial instruments. We believe that a comprehensive reassessment of the accounting requirements, including the measurement objective, for financial instruments is needed to reduce the significant complexity in this area and is responsive to recommendations made by both the FCAG and the Group of 20. However, we believe the need to reassess measurement objectives extends beyond financial instruments. The requirement to utilize fair value as a measurement objective is pervasive throughout the accounting literature and, in many instances, the decision to utilize this measurement objective was made years ago, prior to the establishment of a consistent fair value framework under Statement 157. Accordingly, we also recommend that in the future the Board reevaluate the measurement objective for nonfinancial liabilities, which can present significant fair value measurement challenges. We believe it is critical that this reevaluation not be made in isolation, but

instead contemplate the broader conceptual framework, other ongoing projects (e.g., revenue recognition, including the measurement of a vendor's obligations under a contractual arrangement), and the existing accounting literature. In our view, a conceptual framework that establishes the objectives of financial reporting and the measurement alternatives best suited to meet those objectives, serves as the foundation for the development of consistent and conceptually sound global accounting standards. As such, we continue to urge the Boards to move expeditiously in their joint project on the conceptual framework, particularly as it pertains to measurement. The decisions reached in that project will provide the structure needed to address the many challenging issues faced by the Boards in their development of high quality global accounting standards, including the measurement of nonfinancial liabilities.

* * * * *

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst & Young LLP

Attachment A

Example regarding bid-ask spread

Consider a derivative liability transaction whereby an end-user takes a short position in an option that is trading with a bid-ask spread of 15-20 quoted in terms of volatility points (vols). In this example, the end-user would enter the transaction and receive a premium based on the bid price of 15 vols (i.e., the price at which the dealer is willing to buy, or go long, the option). Under an exit price model, the end-user would likely measure the fair value of this short option at or near the ask price based on 20 vols, as that is the price a dealer would charge to sell, or take on a short position, in the option. As such, the reporting entity would recognize a loss resulting from the difference between the transaction price and the assumed exit price resulting from the bid-ask spread. Conversely, the dealer would recognize a gain. Under a reentry price concept however, the end-user would measure the fair value of the liability at the bid price, the price it would receive if it were to issue (or re-enter) the transaction at the measurement date and therefore recognize no gain or loss. From the dealer perspective, a reentry price concept would seem to conflict with the practice of recognizing a Day 1 gain on transactions, even in situations in which the bid-ask spread is observable. It should also be noted that, even in situations in which it is applied, the mid-market practicability exception in Statement 157 would serve only to reduce this difference, not eliminate it.