



RUCCI, BARDARO & BARRETT PC
Certified Public Accountants and Business Advisors

April 12, 2007



Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856

LETTER OF COMMENT NO. 41

Dear Sir:

I am writing to express my personal opinions in reference to your Invitation to Comment regarding Valuation Guidance for Financial Reporting. My opinions do not represent those of my firm nor of any of the valuation organizations to which I belong. They are mine alone. My credentials are attached to this letter.

In *Facts about FASB*, you state: "The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." Since 1973, you have accomplished your mission so effectively that our financial accounting and reporting and our markets have been the platinum standard for the world. The American people, American business, and markets around the world owe you a great debt for your steadfast efforts to provide financial statements that faithfully represent reality in a clear and comprehensible manner. This is not a compliment; it is a fact.

However, I suggest that **fair value accounting and reporting (FVAR)** represents a theoretical and practical quagmire that may create chaos for the remarkable structure you have built. I also suggest that, unless FVAR is utilized differently than currently proposed, it may be impossible to deliver the guidance needed to bring FVAR to the level of reliability and credibility that can satisfy the attest function and the regulators.

I respectfully submit the following considerations for your review. I have simplified them for brevity. They are **my opinions** regarding what I believe are the challenges faced by any organization seeking to provide guidance for FVAR. A more detailed presentation of the logic behind them is available upon request.

Consideration !: FVAR is a finance discipline. There are fundamental differences between the accounting and finance disciplines that FVAR, as currently proposed, does not and cannot faithfully represent. It is my opinion that these differences cannot be resolved through guidance or regulation.

Accounting is a 600 year old science of historical data collection, measurement, and presentation. It is governed by rules/standards regarding the precision with data is collected, measured, recorded, and presented and the relationship of that data to identifiable, verifiable events. By its nature, it is static and fundamentally objective and empirical (i.e. computed from observed values rather than from theoretical considerations). Accounting provides the valuable function of providing users with transaction-based data,

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measured and codified at precise points in time, and traceable to cash. Certainty and "risk-free" information attributes are goals of financial accounting, although gray areas exist that require the use of informed professional judgment.

Finance, about 70 years old, is the futuristic art of forecasting, statistical analysis, valuation, strategic planning, and investing. It is guided by principles conceived at the most abstract, idealized level and based on theoretical analyses of economies, markets, companies, and projects, all of which are complex, "living," evolving organisms. By its nature, finance is dynamic, ever-changing, fundamentally subjective, and theoretical. Model inputs are selected and quantified using assumptions, data derived from statistical analysis, statistical analysis, and informed professional judgment rather from specific events. Risk and uncertainty are key inputs and also attributes of the resulting model outputs.

Finance cannot exist without accounting. Accounting provides the verifiable raw data that finance uses as a base for its estimations and opinions. I believe that no amount of guidance can bring about the convergence of these two disciplines without violating the attributes and important functions of one or both.

Consideration II: The gray areas within accounting and within finance are fundamentally different. FVAR, as currently proposed, does not and cannot faithfully represent these. It is my opinion that these differences cannot be resolved through guidance or regulation.

The accounting profession engages in debates regarding how accurately and faithfully data is represented in financial reporting and how accuracy and faithfulness can be increased. Misrepresentation can be identified – and punished – because it can be traced to cash (i.e. verifiable data) in some manner.

Finance practitioners (especially business appraisers) debate over the appropriate model inputs and assumptions to consider, the combination and magnitude of assumptions and inputs, how to best quantify inputs, what models to use, and whether model outputs properly represent a reasonable, defensible understanding of economic reality and potential. This occurs for every single project or appraisal, not just once in a while. In addition, appraisers have distinct and divergent opinions about correct mathematical notation and the definitions of the terms to be used. They may even disagree with their own prior stated positions, depending on appraisal "facts and circumstances" or changes in financial convention or theory. Naiveté, poor judgment, lack of craftsmanship, or dishonest analysis can be identified – but, except for the most blatant cases, are hard to prove or punish because they are matters of opinion.

I believe that no amount of guidance can resolve this problem. If business appraisal becomes regulated and "cookie cutter," it will no longer reflect the realities of "living" economies, markets, companies, and projects. Valuing these realities is not equivalent to appraising tangible property.

Consideration III: FVAR intends to present the current market "values" of balance sheet items, rather than their historical cost, under the assumption this will improve the relevance of financial statements. It is my opinion that modifying the balance sheet in this manner may perpetuate the common confusion of "cost" with "value" under a going



concern premise and mislead users of financial statements. Guidance and disclosure may or may not solve this problem.

I suggest cost does not equal value under a going concern premise, though they might, arguably, be equal at an inflection point such as a sale or liquidation. Historical or current cost does not indicate the kind or magnitude of future net economic benefits that will accrue to a going concern entity from its net resources, separately or in aggregation. Risk and reward, prospective concepts, are the key drivers of value. Cost, a historical concept, helps define risk but not reward. For instance, cost savings are risk mitigations but not rewards.

Under a going concern premise, the balance sheet provides users with: A snapshot of the configuration of net resources currently available to the firm; insight regarding how the firm has articulated those net resources over time and in comparison with peer firms; a context for understanding firm performance; a list of individual net resources that have "utility and value (future economic benefit)" (CON 6, [11]) to the firm. CON 6, [14] and [15] state, "Resources or assets are the lifeblood of [the firm]." I suggest, however, that they are the anatomy and physiology of the firm and that the "lifeblood" is the firm's people and processes, *neither of which is found on the balance sheet.*

I further suggest that balance sheet items are not, in themselves, "probable future economic benefits" or "probable future sacrifices of economic benefits" per CON 6, [25] and [35]. Rather, they are the **inputs that will produce** those net economic benefits, considering the "state of the system" (i.e., depending on how effectively and efficiently the firm uses them in its processes to produce outputs). Thus, other than cash, cash equivalents, A/R and equity, the "values" recorded on the balance sheet represent prepaid or deferred costs to the firm, either "as they would be today" or "as they were when incurred."

Yet, by its very title, FVAR indicates to the financial statement user that he is reading about the current value of the entity via the current "value" of its assets and liabilities. I believe this is potentially misleading and perpetuates the general confusion between cost and value. Careful guidance will be needed to ensure this is properly disclosed and understood.

Consideration IV: FVAR may produce unforeseen and ironic effects on today's highly prized market data. It is not clear how guidance could resolve this in a simple and meaningful manner.

Fair values are supposed to be estimated using actual market data where available, and realistic proxies for market data where it is not available. Yet, for public companies, fair value estimates **will become market data** as they get embedded in 10-Ks and other public documents.

Thus, all market data may become non-market based, since it will, directly or indirectly, contain large segments of "appraiser best estimates" rather than actual transaction results. Financial statements may become a *Reader's Digest* of appraiser speculations. Neither humans nor computer algorithms may be capable of separating the "actual" from the "fictitious." This will clearly affect market decisions in unforeseen ways.



Consideration V: The addition of FVAR to historical financial statements may affect the FASB stated goal of “credible, concise, transparent, and understandable financial information.” Increased guidance and disclosure may not relieve financial statement preparers and users of these difficulties.

Current users of financial statements assume they are being provided with verifiable factual information, governed by complicated, but thoughtfully constructed, rules. It is not a perfect system, but it works pretty well.

Once FVAR begins to insert data into financial statements based on estimation, not measurement, the additional knowledge, time, and expense required to prepare, parse, and attest to FVAR financial statements will increase by orders of magnitude. The divide between naïve and sophisticated investors may widen, leaving naïve or less-sophisticated investors more dependent on an array of “experts” than they now are.

PROPOSED SOLUTION: Rather than require companies to issue historical financial statements that contain fair value information, the FASB could invite or require companies to supplement historical financial statements with a Fair Value Balance Sheet and Income Statement.

Fair Value Financial Statements would not co-mingle accounting and appraisal (i.e., fair value) information. They could be prepared by appraisers just as they prepare valuations today and would include proper disclosures, assumptions and limiting conditions. They could continue to be loosely guided by common appraisal standards without having to be subjected to the rigors of financial accounting standards.

Under this scenario, FVAR could retain the status most appropriate to estimates based on informed professional judgment rather than requiring it to achieve the status of audited accounting records. It could continue to respond flexibly to sea changes in the markets without having to issue a never-ending series of official pronouncements regarding changes in theory and practice. Users would understand the degree of reliability and credibility associated with what they were reading.

Other headaches might be avoided. Swings in fair values due to market changes or appraiser opinions would not cause historical financial statements to lose their overall stability or encourage gaming the system. The FASB could provide relevant, worthwhile supplemental information to users without having to become experts in and regulators of the appraisal profession. The PCAOB and the auditors could be spared having to attest to a never-ending series of estimates that differ by appraiser, by economic cycle, or by theories coming into and out of vogue. The SEC and lawyers could focus on verifiable issues of wrongdoing and misrepresentation rather than on disputes over opinions about errors in judgment regarding model inputs and assumptions.

Would there need to be some kind of oversight and guidance for these supplemental statements? Of course. The FASB is the ideal organization to provide oversight. It has superb mechanisms in place to respond to inquiries, make decisions, and resolve disputes. The FASB could assist the appraisers in avoiding deadlock during their ongoing debates. Since turf battles are endemic to the business appraisal profession and there are excellent appraisers



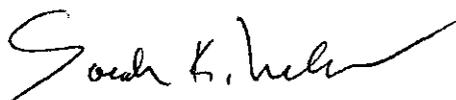
from both the public accounting and finance worlds, the FASB could referee and ensure that no single group of business appraisers with a particular set of biases "take over" the whole effort.

A 100% neutral board of seasoned appraisers from all competing appraisal associations and organizations would be a "best case" mechanism by which to prepare and issue ongoing guidance for fair value estimation and reporting. Careful board member selection, short board seat terms, and thoughtfully developed board governance would help build the board into an effective working team.

In closing, the concept of including valuation estimates in a financial reporting context is worthwhile. There are many insights regarding the "life force" of companies that cannot currently be presented in historical financial statements but would be relevant and useful to users. A separate set of Fair Value Financial Statements might provide the venue for this kind of information yet ensure that users are not misled. The oversight and guidance needed for this approach would be important but of a different nature and tone than that required for historical financial reporting.

I would be please to discuss these considerations and proposed solution in more depth and to clarify any comments contained herein.

Respectfully,



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Educational and Professional Background

MBA, DePaul University, Chicago, IL.

BA, Randolph-Macon Women's College, Lynchburg, VA.

Accredited Valuation Analyst (AVA). National Association of Certified Valuation Analysts.

Career Experience

Rucci, Bardaro & Barrett, P.C. – Senior Manager, Valuation and Litigation Support Services. Specialties include valuation of intangible assets and complex transactions.

Department of Defense Office of Force Transformation at Naval Postgraduate School – Visiting research scholar. Valuation of intangible assets, information systems, and human capital. Use of real options analysis to solve valuation problems. Creator of new field, sub-corporate finance.

Intellectual Capital Ventures, LLC – Founder. Consulting to development stage technology companies.

Center for Advanced Valuation Studies – Founder, in partnership with American Society of Appraisers Business Valuation Committee.

KPMG LLP, Forensic & Litigation Services Midwest – Director of Practice Development

Illinois CPA Society & American Institute of CPAs – Program Development Manager with specialty in Business Valuation. Work foundational to AICPA ABV designation.

CSA Financial Services, Inc. & CCF, Inc. – Chief Financial Officer

Professional Associations

Appraisal Issues Task Force, Candidate

National Association of Certified Valuation Analysts

Massachusetts Society of CPAs – Associate Member, Business Valuation and Litigation Support Committee

Published Work and Presentations

"Critical Issues in Financial Reporting." Workshop regarding fair value reporting. Russell Bedford International 23rd Annual International Conference, Vancouver, Canada. October, 2006.

Nelson, Sarah (2005) "Sub-Corporate Finance: New Sources of Data for Real Options Analysis," Academic research paper and presentation. 9th Annual Real Options Conference, Paris, France. June 2005.

Nelson, S. et al (2005) "Knowledge Valuation & Real Options Analysis to Support Capabilities-Based Planning," Vol. 1. Office of Force Transformation, Department of Defense. Technical Report #101, March 2005.

Nelson, S. & Housel, T. (2005) "Knowledge Valuation Analysis: Applications for Organizational Intellectual Capital," *Journal of Intellectual Capital*, January 2005 Special Issue.

Knowledge Management Cluster, Denver. "Kolmogorov Meets Pacioli and Bachelier: Financial Valuation for Intellectual Capital Assets." Presentation, January 2005.

Valuation section of Chapter 6, Housel, T. and Bell, A. (2001) *Measuring and Managing Knowledge*. McGraw Hill Irwin: NY.

Writer, developer, editor of wide range of books, courses, conferences, case studies, and examinations for the business valuation profession.

