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Sarah E. Smith
Managing Director
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CL 146A

May 30, 2003

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH, United Kingdom

By email to: iasb@iasb.org.uk

Re: Proposed Amendments to IAS 39, *Financial Instruments: Recognition and Measurement*

Dear Sir David:

We have monitored the International Accounting Standard Board's (the "Board") deliberations on the proposed amendments to International Accounting Standard 39, *Financial Instruments: Recognition and Measurement,* (IAS 39) with great interest. We submitted our comment letter to the Board on the proposed amendments and participated in the roundtable discussions in March 2003. We are writing now to offer our views to the Board about certain issues related to fair value measurement. Goldman Sachs is a leading global investment banking, securities, and investment management firm. We have successfully applied fair value accounting across a variety of markets in different stages of development for decades. We believe our "real world" experience makes us uniquely qualified to provide valuable input to the Board on the important issues it is considering in connection with its proposed amendments to IAS 39.

The fundamental principle underlying our views is that a strict hierarchy for estimating fair value should not be required. We observe a hierarchical approach has also gained traction with the Financial Accounting Standards Board (FASB), presumably in response to several well-publicized cases where firms abandoned (or never implemented) sound fair value principles. We appreciate the difficulties associated with developing principles-based standards that also minimize the potential for their abuse. However, we are very concerned the current approach may preclude the use of sound judgment and may create more problems than it solves. We agree that each of the proposed methods for estimating fair value is a useful valuation tool in appropriate circumstances; however, we believe the requirement to apply the methods in a strict hierarchical manner is inappropriate. We believe there are circumstances when accurate pricing involves judgment and market knowledge. In these cases, the use of a hierarchy could result in the inappropriate estimation of fair value and revenue recognition for dealers.

The Attachment to this letter reproduces paragraphs 95 through 100D of IAS 39 as if they were amended as proposed in the Board's Exposure Draft. We have marked the proposed amended paragraphs to show the changes we believe would improve IAS 39 consistent with the objective of reporting values that will reflect the amounts entities would receive or pay if assets were sold or liabilities were settled—the essence of fair value. In the following paragraphs, we discuss the rationale underlying our suggested changes.

Paragraphs 99-100A

Fair value hierarchy. Through a series of conditional "if" statements, paragraphs 99-100A address the valuation of financial instruments based on a pricing hierarchy that asserts the best evidence of fair value first is a published price quotation in an active market, next a recent market transaction between knowledgeable, willing parties in an arm's length transaction and, finally, a valuation technique. We believe the proposed fair value hierarchy is too prescriptive because there are circumstances when accurate pricing involves judgment and market knowledge. In these cases, the use of a hierarchy could result in the inappropriate estimation of fair value and revenue recognition for dealers. Accordingly, we suggest deleting the conditional "if" statements in paragraphs 100 and 100A, and adding the word "normally" in the first sentence of paragraph 99 to permit other methods of valuation in appropriate circumstances. We also suggest adding a requirement in paragraph 100 that entities apply judgment in determining the best estimate of fair value, using all information available in the circumstances, considering prices for recent market transactions between knowledgeable, willing parties in an arm's length transaction, as well as prices for similar assets or similar liabilities and the results of other valuation techniques.

Paragraph 99

Block discounts. Paragraph 99 states the fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. We disagree with this proposition because it would preclude an entity that holds a large block of an unrestricted security for which a quoted market price in an active market is available from discounting the market price of that security for the purpose of determining the fair value of its holding.

Our experience demonstrates that liquidating a large block over a relatively short period of time will depress the market price. Perhaps the clearest example of this is a situation in which we enter into a block trade as facilitation for a customer who wants to sell a large block of securities. Based on our experience, purchases and sales of block trades can be at prices that are significantly different from the quoted market price for the security. In addition, academic research has clearly demonstrated that if an entity holds a sufficiently large position in an unrestricted instrument compared to its trading volume, any attempt to liquidate that position quickly will negatively affect the observable market price. Therefore, multiplying the observable market price times the quantity held likely will overstate fair value and result in inappropriate revenue recognition.

Some have noted the issue of block discounts is a unit-of-measure issue. We agree and believe the unit of measure for a dealer should be the entire block and not pieces of the block because of the revenue recognition issues discussed above.

One of the chief criticisms of block discounts is their subjectivity. We observe the international accounting literature requires preparers of financial statements to make numerous complex judgments that result in subjective estimates, such as those related to pensions, impairment of assets, provisions, contingent liabilities, contingent assets—and likely soon—share-based payments. Few measurements can claim absolute reliability. But we believe most of the Board's constituents would agree that financial statement recognition of estimated amounts that are approximately right—valued in good faith and in accordance with well-controlled processes consistently applied—is preferable to the alternative: recognizing a value known to be wrong. We do not understand why block discounts should be treated differently from other critical estimates inherent in financial accounting and we take issue with an approach that would require entities to value a security at a price they know is not indicative of fair value merely for the sake of objectivity. To do so would be misleading to financial statement users.

We believe one way to address the issue of subjectivity would be to require the consistent application of the observed block discount until the quantity held could be rapidly absorbed by available market liquidity.

Thus, in valuing the block of securities prior to liquidation, we believe it is appropriate to factor in a discount to the quoted market price. If we were to do otherwise, we would write the block up and realize an immediate gain on acquisition, only to incur a loss shortly thereafter when the position is sold. Accordingly, we have proposed certain changes to the penultimate sentence of paragraph 99 to address this concern.

Paragraph 100A

Recognition of initial dealer profits. Paragraph 100A addresses the valuation of financial instruments when no active market exists and a valuation technique must be used. Paragraph 100A would require an entity to calibrate the valuation technique and test it for validity using prices from actual transactions. When the instrument being valued is purchased or sold in an arms-length transaction, paragraph 100A also states the valuation would be expected to result in an amount that equals the fair value of the consideration given or received.

At a minimum, we are concerned paragraph 100A could be interpreted as barring the recognition of initial "day one" dealer profits, even when all significant inputs to valuation models are considered observable. If interpreted in this manner, this would be a significant departure from the approach adopted by the FASB in EITF Issue No. 02-3 (although we remain concerned about the impact Issue 02-3 has had on revenue recognition and risk management principles). We have therefore suggested the relevant text be deleted to avoid any potential ambiguity.

It has been six months since Issue 02-3 became effective. We believe Issue 02-3 provides companies with an opportunity to time revenue recognition by entering into new contracts that create observability. This concerns us deeply, because it means revenues may be recorded in periods that are different than when the underlying economic activity occurred.

Issue 02-3 has also ruptured the fundamental link between the financial statements and risk management information. For decades, the two shared the same definition of fair value. Numerous public and private sector initiatives encouraged and fostered this approach. The reasons are plentiful, which is why we continue to manage our risks consistent with economic fair value and not the Issue 02-3 definition of fair value, which was developed in the wake of several well-publicized abuses by firms who abandoned (or never implemented) sound fair value principles. For example, risk management information has predictive value and is crucial in analyzing whether the financial statements make sense as a result of market movements. In turn, financial statements have feedback value and are crucial in highlighting potential unidentified risks.

In our view, if portfolio valuation principles and practices are properly applied, portfolio gains and losses will be computed from changes in the fair value of the portfolio. As such, these gains and losses should be recorded, even if they result in a recognition event on day one, regardless of whether all significant inputs are observable. Such gains or losses may result for a number of reasons, including:

- Dealers may price a contract at a margin higher than the cost associated with hedging the contract
- A new transaction may have an effect on the rest of a dealer's portfolio, providing a natural offset to existing positions, reducing the need for liquidity or close-out cost adjustments
- New information arising from the most recent transaction is used to inform the valuation of the existing portfolio

It would be inappropriate to ignore any of these recognition events as they result merely from the consistent application of a valuation methodology that is continuously updated to incorporate the best and most recent market information into modeling inputs.

Paragraph 100D

Using entry prices to value loans. Paragraph 100D states that the fair value of a debt instrument, such as a loan asset, can be determined by reference to *the market conditions that existed at its acquisition or origination date* and current market conditions *or interest rates currently charged by the entity or by others* . . .. Those words suggest fair value should be determined on the basis of entry prices. We are concerned they could be used to value large loan commitments to substantial borrowers on the basis of entry prices. We believe exit prices are the essence of fair value—the amount at which an asset could be exchanged or a liability settled. We suggest removing the words as indicated in the Attachment (and italicized here).

Paragraph 100E

Valuation of OTC derivatives by dealers. We have suggested a final paragraph (paragraph 100E) that would explicitly address the valuation of over-the-counter (OTC) derivatives by dealers. The reason for the paragraph is our concern that paragraph 99 could be interpreted as requiring OTC derivatives portfolios to be valued on a contract-by-contract basis using bid or offer prices. We interpret paragraph 99 as applying to cash instruments and exchange-traded derivatives.

Our suggested paragraph would require dealers to follow long-standing practices for the valuation of derivatives portfolios in accordance with The Group of Thirty Report, *Derivatives Principles and Practices*. The G-30 Report recommends that derivatives be valued based on mid-market levels less specific adjustments for net open risk positions, or on appropriate bid or offer levels. Mid-market valuation adjustments allow for expected future costs such as unearned credit spread, close-out costs, investing and funding costs, and administrative costs. We would add that since the issuance of the G-30 Report in 1993, many other public and private sector contributions to the body of best practices have acknowledged portfolio valuation as the appropriate methodology for valuing OTC derivatives.

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We appreciate the opportunity to provide you with our views on certain aspects of fair value measurement. If you have any questions regarding our comments, please do not hesitate to contact me at 212-902-5675, Matt Schroeder, Managing Director—Accounting Policy at 212-357-8437, or Stephen Davies, Managing Director—European Controller in London at (20) 7774-3804.

Sincerely,

<u>/s/Sarah Smith</u>

Sarah E. Smith
Managing Director
Chief Accounting Officer

Cc: Mr. Thomas E. Jones, Vice-Chairman of IASB
Mr. Magnus Orrell, Project Manager, IASB

ATTACHMENT

Goldman Sachs Suggested Changes to IAS 39 Relating to Fair Value Measurement
Marked to Show Changes from "Clean" Version of IAS 39 Amendments

Fair Value Measurement Considerations

95. In determining the fair value of a financial asset or a financial liability for the purposes of applying this Standard or IAS 32, an entity shall apply paragraphs 98-100~~D~~E.

96. - 97. [deleted by IASB]

98. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale.

Fair Value~~Active Market~~: Quoted Prices in Active Markets

99. The existence of published price quotations in an active market is normally the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability. A financial instrument is regarded as quoted in an active market if quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction provides evidence of the current fair value provided there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an entity has matching asset and liability positions, it may appropriately use mid- market prices as a basis for establishing fair values. The fair value of a portfolio of identical financial instruments is the product of the number of units of the instrument and its quoted market price reduced, if necessary, by a block discount to arrive at the best estimate of fair value. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

Fair Value: Valuation Technique~~No Active Market: Recent Market Transaction~~

100. ~~If the market for a financial instrument is not active, the best evidence of fair value is obtained by reference to recent market transactions between knowledgeable, willing parties in an arm's length transaction. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is~~

~~determined by reference to current prices or rates for similar financial instruments, as appropriate.~~If quoted market prices in active markets are not available, the entity shall apply judgment in determining the best estimate of fair value, using all information available in the circumstances. The best estimate of fair value shall consider prices for recent market transactions between knowledgeable, willing parties in an arm's length transaction, as well as prices for similar assets or similar liabilities and the results of other valuation techniques.

~~No Active Market: Valuation Technique~~

100A. ~~If an entity cannot otherwise determine fair value, it uses a valuation technique to estimate fair value.~~ The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. ~~An entity calibrates the valuation technique and tests it for validity using prices from actual transactions. For example, when the instrument being valued is purchased or sold in an arm's length transaction, the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received.~~

100B. Valuation techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

100C. In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price for the financial instrument. In applying discounted cash flow analysis, an entity uses the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made. When the term of an instrument extends beyond the period for which market prices are available, the valuation technique uses market prices for the period they are available and reasonable extrapolations of those market prices for later periods on the basis of historical experience of price changes under normal market conditions and all other available information. In particular, any assumed change in market prices is supported by reasonable evidence consistent with any available market forward prices.

100D. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a debt security or loan asset), its fair value can be determined by reference to ~~the market conditions that existed~~

~~at its acquisition or origination date and~~ current market conditions ~~or interest rates currently charged by the entity or by others~~ for similar debt instruments (i.e. similar remaining maturity, cash flow pattern, currency, credit risk, collateral, and interest basis). Alternatively, provided there is no change in the credit risk of the debtor after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date.

100E. For dealers, over-the-counter derivatives shall be valued as a portfolio in accordance with The Group of Thirty Report, *Derivatives Practices and Principles*, based on mid-market levels less specific adjustments for net open risk positions, or on appropriate bid or offer levels. Mid-market valuation adjustments allow for expected future costs such as unearned credit spread, close-out costs, investing and funding costs, and administrative costs. Marking to mid-market less adjustments specifically defines and quantifies adjustments that are implicitly assumed in the bid or offer method.