

16 October 2009

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir/Madam

Re: Exposure Draft *Fair Value Measurements*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB's exposure draft *Fair Value Measurements* (the ED). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

As paragraph 100 of the IASB's Framework says, "a number of different measurement bases are employed to different degrees and in varying combinations in financial statements." Those measurement bases fall into one of two broad measurement categories: cost-based measurement approaches and some sort of up-to-date measurement (or current value) basis. Fair value is an example of a current value measurement basis. Existing IFRS defines the fair value notion in fairly broad terms and provides guidance on estimating fair value that is not consistent in all respects. As a result, the various references in existing IFRS to 'fair value' are currently interpreted to mean different things and, in some cases, the same references are being interpreted to mean different things.

The IASB's key objectives in issuing the ED are to clarify what is meant by the term 'fair value' and to provide guidance on how fair value can be estimated. EFRAG welcomes the IASB's decision to provide this additional clarity and guidance because, if entities are interpreting a particular reference in existing IFRS to 'fair value' differently, the proposed Fair Value Measurement standard will result in greater comparability.

In the US there is already an accounting standard clarifying and providing additional guidance about fair value and another objective of the IASB's ED is to try to reach a common understanding on these matters. We support these efforts to achieve convergence with the FASB as the need for the development of a consistent global approach to fair value measurement has become more apparent due the recent financial crisis.

However, knowing exactly what a particular measurement basis entails is important not only because it enables the measurement basis to be implemented appropriately but also because it has implications for when that measurement basis (rather than some other measurement basis) should be used. For example, if fair value is described in a way that makes it an almost 'generic' term, it is possible that it will be an appropriate measurement basis in more circumstances than if fair value is described more narrowly.

So, because the ED proposes to describe fair value in a way that we consider to be more precise and narrower than the existing description, we have had to consider whether it would be appropriate to use fair value as described in all the circumstances in which existing IFRS requires fair value to be used. Furthermore, if we think it would not be appropriate, we have had to consider whether that meant we had concerns about what fair value is and how it should be estimated (the so-called 'how to issue') or concerns about when it should be applied (the 'when to issue').

In the appendix to this letter we set out our detailed comments to the questions asked in the ED. However, to summarise:

- We broadly support the fair value measurement framework described in the ED in so far as it relates to financial assets and financial liabilities that are required by existing IFRS to be measured at fair value.¹ However, we have concerns related to certain aspects of the proposal as it applies to such assets and liabilities. In particular:
 - We do not agree with the proposal that the fair value of a liability should on all occasions and for all liabilities reflect non-performance risk. In our view, when fair value is being estimated on initial recognition of a liability it should reflect non-performance risk only when that risk is reflected in the transaction price; and, when fair value is being estimated on subsequent remeasurement of a liability, that fair value should reflect changes in non-performance risk only if the liability is held for trading purposes and actively traded. In our view in all other circumstances it is inappropriate to reflect non-performance risk in the amount at which a liability is measured and the fair value definition should be amended accordingly.
 - We do not support the proposal that the reference market for determining the fair value of a financial asset or financial liability should be the most advantageous market to which the reporting entity has access. In our view the reference market should be the market the reporting entity would usually use.
- However, we do not support the application of fair value as defined and described in this ED to all non-financial items required by existing IFRS to be measured at fair value.²
 - Our concerns in the case of non-financial items relate to the complexity and lack of clarity of aspects of the ED (principally the proposals about highest and best use, but other proposals as well) and to the doubts we have about whether fair value as defined would be the most useful measure in every circumstance in which existing IFRS requires fair value to be used for a non-financial item.
 - We have considered whether these concerns are a 'how to' concern or a 'when to' concern, and have concluded that we disagree with the ED's proposals about when to apply fair value as defined, rather than with how

¹ For simplicity, although the letter hereafter refers simply to 'financial assets' and 'financial liabilities', those references should be read as being references to "financial assets and financial liabilities that are required by existing IFRS to be measured at fair value".

² Hereafter this letter refers to 'non-financial items required by existing IFRS to be measured at fair value' simply as 'non-financial items'.

fair value is defined. From this we have concluded that such non-financial items should not be within the scope of the Fair Value Measurements standard.

- We note several instances where fair value measurements are currently used where we think either a different measurement objective may provide more useful information and/or we foresee application difficulties.
- We understand the IASB has carried out a review of each reference in existing IFRS to 'fair value' to consider whether those references are references to fair value as described in the ED. We understand in that work highlighted that in some cases existing practice has been to interpret the fair value requirement rather differently from the proposed description in the ED. Nevertheless, the ED proposes that almost all the existing references in IFRS to fair value should be treated as references to fair value as described. For the reasons summarised briefly above, we do not agree with that conclusion but perhaps more fundamentally we believe it is really important that the IASB should reconsider the work it has done and the conclusions it has reached on this issue and subject the results of that reconsideration, together with the accompanying reasoning, to public consultation and debate.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Jeff Waldier or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix EFrag's detailed responses to the questions asked

DEFINITION OF FAIR VALUE AND RELATED GUIDANCE

Question 1—The exposure draft proposes defining 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’ (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs.

Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

Summary of EFRAG's view:

- We broadly accept the proposed new definition of fair value in so far as it is applied to financial assets and financial liabilities required by existing IFRS to be measured at fair value. This acceptance is though subject to our comments later in the letter about reflecting own credit risk in the measurement of liabilities.
- We do not accept the new definition is appropriate for use with most non-financial items, because:
 - aspects of the new definition and guidance appear, in the way they will apply to non-financial items, to be unclear, difficult to understand and apply, and internally inconsistent; and
 - we remain unconvinced that the use of fair value as defined for non-financial items will result in information that is more decision useful than the information that will result from certain other current value measurement bases.
- As we have concluded that our concerns about the application of the definition to non-financial items are a ‘when to’ issue rather than a ‘how to’ issue, we are supporting the proposed definition (subject to our concerns about own credit risk) but at the same time arguing that it should be applied much more narrowly than is proposed.

- 1 The proposed definition of fair value comprises a number of elements:
 - (a) The first element is that fair value should be an exchange notion—in other words, the price to sell an asset or transfer a liability to another party—rather than say an in use notion (in the case of an asset) or a fulfilment notion (in the case of a liability).
 - (b) The second element is that fair value is a market participant-based notion, rather than say an entity-specific notion.
 - (c) The third element is that fair value should be based on an exit notion rather than say an entry notion.

Therefore, agreement with the definition means agreeing with each of these elements.

- 2 The debate about how to define 'fair value' is closely related to the debate about when fair value should be used in financial statements. For example, one could agree a particular definition of fair value (the 'how to' issue) but then argue that fair value defined in that way should be used only rarely in financial statements (the 'when to' issue). This tension between 'how to' and 'when to' is difficult to resolve other than arbitrarily unless it is possible to narrow down the meaning of fair value in some other way. We have tried to do that by taking as the starting point for our analysis the existing IFRS definition of fair value, and by accepting what that definition tells us fair value is.

Exchange notion v in use/fulfilment notion

- 3 The first element in the proposed definition is that fair value should be an exchange notion—in other words, the price to exchange an asset or liability with another party—rather than say an in use notion (in the case of an asset) or a fulfilment notion (in the case of a liability). The existing definition of fair value in IFRS already uses an exchange notion for assets and we believe it is not controversial that the proposed new definition of fair value measurement retains a similar exchange notion for assets.
- 4 However, the position is not as clear for liabilities because the existing definition refers to a settlement notion, and 'settlement' encompasses both fulfilment and transfer. We accept that, when financial liabilities are measured under IAS 39 at fair value, it is a transfer notion that is being used. On the other hand, we think practice is more varied when non-financial liabilities are concerned, so it is reasonable to ask what will result in more useful information. (The proposal that the definition should focus on the transfer value of a liability, rather than its fulfilment value, is discussed further in Question 7.)

Market participant-based notion v entity-specific notion

- 5 The second element in the proposed definition is that fair value is a market participant-based notion, rather than say an entity-specific notion. As we understand it, what the ED really means by this is that:
- (a) fair value should be estimated by taking into account only those cash flows that would be taken into account by someone other than the holder of the asset or liability; in other words, entity-specific cash flows should be ignored; and
 - (b) one should assume that, like with the existing definition, the two parties are "knowledgeable, willing parties" and that the transaction is at "arm's length".
- 6 We agree that fair value should be based on "knowledgeable, willing parties" transacting at "arm's length".
- 7 Furthermore, we note that existing practice under IAS 39 seems to ignore entity-specific cash flows when estimating the fair value of financial assets and financial liabilities. Users of financial statements seem to find the resulting information useful. Again, however, practice seems more varied for non-financial items and we are not persuaded that that using non-entity specific numbers in some of the circumstances in which fair value measures are required to be used for non-financial items will result in the most decision-useful information being provided to users.

Exit notion v entry notion

- 8 The third element of the proposed definition is that fair value should be based on an exit notion rather than say an entry notion. The existing definition is not specifically an entry notion or an exit notion. However, the IASB has concluded (in paragraph BC28) that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market. From that, the IASB has taken the view that the exit notion v entry notion debate is a non-issue; in other words, when there are perceived to be differences between the entry price and the exit price of a particular asset or liability in the same market, that is actually because prices from different markets are being compared.
- 9 We agree in principle with this conclusion. Putting aside transaction costs, if one party transfers an asset or liability to another party, the transfer price for the transferor will be identical to the transfer price for the transferee. Of course, if that transferee tries to transfer the transferred asset or liability on to a third party immediately after the first transfer, it might find that the transfer price available is different. However, that will not be because the entry and exit price are different but because the 'entry market' and 'exit market' are not the same.
- 10 Having said that, we think the way the issue is discussed in the ED and supporting material is flawed and that, as a result, the case for concluding that fair value should be based on an exit notion rather than an entry notion has not been satisfactorily made. Our reasoning is as follows:
- (a) The discussion in paragraph BC28 does not seem to be reflected in some other parts of the ED. In particular, the IASB argues in the footnote to paragraph BC28 that bid-offer spreads exist only because of transaction costs, and that therefore the existence of a bid-offer spread does not mean that there is a difference between the entry and exit prices in that market. Yet in paragraph BC97, the ED explains that "the Board decided not to specify what, if anything, is in a bid-ask spread in addition to transactions costs." (As a result, paragraph 55 proposes to allow entities to use "the price within a bid-ask spread that is most representative of fair value.") If bid-ask spreads involve more than just transaction costs, it follows that entry price and exit price are not the same.
 - (b) It is a matter of fact that an entity is not always able to both buy and sell a particular item in the same market. It follows that it will often not be indifferent to whether IFRS requires it to use an exit price or an entry price from a particular market.
- 11 So, the new definition is proposing something that is not in the existing definition—that fair value should be based on an exit notion—and we do not find the reasoning behind the proposal convincing. Nevertheless, we also understand that currently fair value is viewed as an exit price notion when it is applied to financial instruments. Practice is more varied when the fair value notion is applied to non-financial items.

Summary conclusion

- 12 It follows from this that, when existing IAS 39 requires a financial asset or a financial liability to be measured at fair value, EFRAG agrees it is requiring a market-participant based exchange-based exit price—subject to our comments later in this letter about own credit risk. The proposed new definition itself seems

to require no change. As we are comfortable with the way fair value is currently applied in the context of IAS 39, we accept the proposed new definition when it is to be applied to financial instruments that are required by existing IFRS to be measured at fair value (except for the own credit risk issue).

13 On the other hand, we are not comfortable with the proposed new definition and related framework being used for non-financial items:

- (a) Partly this is because, as will become clear from other comments in this letter, we think that for non-financial assets and liabilities the application of this new definition is in some respects not clear and thus difficult to understand and apply. That is because, when dealing with such items, there are a number of different markets and uses, and access to markets can differ. When that is the case, we think inconsistencies in the ED become apparent. As a result, for non-financial items the proposed approach would involve too much uncertainty and complexity. We also think that some of the guidance is internally inconsistent. (Please also see our comments on this issue in our response to Question 5.)
- (b) It is also because the proposals in the ED will involve a change in practice and we are not persuaded that the changes proposed will result in improvements in the information provided. In particular:
 - (i) we are not persuaded that it is necessarily useful to measure a non-financial liability at its transfer value as described in the ED. We think the most useful measure of a liability will usually be its fulfilment value, because that is the value that best reflects the future outflows likely to arise in respect of the liability. This issue is discussed later in our letter.
 - (ii) we are also not persuaded that the most useful current value information about non-financial items is provided by ignoring entity-specific cash flows. In other words, we remain unconvinced that the use of fair value as defined for non-financial items in this ED will result in information that is more decision useful than the information that will result from certain other possible definitions. We think that the main reason why current values are relevant measures to use in financial statements is because they reflect the most up-to-date information about the future cash flows arising in respect of the asset or liability that the reporting entity can reasonably expect. However, if that is the objective—to provide information about the cash flows that the reporting entity can reasonably expect—the most relevant information will be provided by measures that take into account the purpose for which the item is being held and the opportunities and costs available to that entity. We do not think that fair value as defined in the ED does that.
 - (iii) we are not persuaded that the focus on exit value, and therefore exit markets, is appropriate in all cases. For example, in circumstances in which fair value is being used on initial recognition, it is often being used as a proxy for cost and in such circumstances the proxy will be better if an entry value—and therefore entry markets—are used.

For example, in a business combination an entity uses many of its own expectations and assumptions in order to determine the consideration it is willing to exchange in the transaction. Those amounts are not hypothetical

and we generally think financial reporting using those entity-specific amounts provides users with more useful information.

- (c) Furthermore, if fair value as described in the ED were to be used to measure the non-financial items required by existing IFRS to be measured, we would have concerns about the reliability of some of those fair value measures because of the absence not only of active markets but also markets of almost any kind.

Indeed, we have heard it argued that a market participant-based measurement basis is preferable to an entity-specific basis because it is more objective. However, as 'active' markets do not exist for many non-financial items, the application of the fair value framework is unlikely to achieve that desired objectivity.

Incidentally, we are not convinced that it is helpful to users to attach the fair value 'label' to some of the fair values that existing IFRS would require of non-financial assets and liabilities. In many cases those amounts will be estimated from level 3 inputs, and we have a concern that labelling those amounts as 'fair value' might imply a level of precision that does not exist, which would be unhelpful for users.

- (d) Finally, we are also concerned about the effort necessary to substantiate all the notions (highest and best use, market participant assumption) for each non-financial item and as a result are not convinced the benefits exceed the costs for some non-financial items.

14 Having concluded that we are broadly comfortable with the proposed new definition and related framework being used for financial assets and liabilities (subject to our comments about own credit risk) but are not comfortable with it being applied to non-financial items, we considered whether our concern is a 'when to' concern (ie we are comfortable with the definition and description, but just do not believe it should be applied to non-financial items) or a 'how to' concern (ie we do not think the ED's definition and description of fair value is appropriate). Bearing in mind how closely related the two issues are, it is not clear to us quite where the line should be drawn. However, we think our concern is probably a 'when to' concern. That is primarily because we see the advantage of having a tightly defined and described notion of fair value, and we do not think that the notion of fair value that seems appropriate for financial items and the valuation basis that seems to us to be appropriate for non-financial items can not always be encompassed in a single tightly defined and described notion. Furthermore, as already explained we accept that fair value is a market participant-based notion but we believe that the most useful current value to use for many non-financial items is an entity-specific value. Accordingly, in our response below to Question 2, we have argued for most non-financial items to be excluded from the scope of the Fair Value Measurement standard.

15 We understand the IASB has carried out a review of each reference in existing IFRS to 'fair value' to consider whether those references are references to fair value as described in the ED. We understand that work highlighted that in some cases existing practice has been to interpret the fair value requirement rather differently from the proposed description in the ED. Nevertheless, the ED proposes that almost all the existing references in IFRS to fair value should be treated as references to fair value as described. We think this is a fundamental aspect of the Fair Value Measurement project and is one that would benefit from further work from the IASB and a public debate of the results of the work and the

reasons behind the conclusions drawn from that work. We think that, if the IASB wishes to make changes to existing practice in this area, it should provide reasoned arguments in support of those proposed changes. We therefore urge the IASB to re-consider this part of its work and to subject the results of that work to a separate consultation.

SCOPE

Question 2—In three contexts, IFRSs use the term ‘fair value’ in a way that does not reflect the Board’s intended measurement objective in those contexts:

- (a) In two of those contexts, the exposure draft proposes to replace the term ‘fair value’ (the measurement of share-based payment transactions in IFRS 2 Share-based Payment and reacquired rights in IFRS 3 Business Combinations) (see paragraph BC29 of the Basis for Conclusions).**
- (b) The third context is the requirement in paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term ‘fair value’, but instead proposes to exclude that requirement from the scope of the IFRS.**

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

Summary of EFRAG’s view:

- We agree that all the exemptions proposed are needed.
- However, we would add other exemptions:
 - We would also exempt certain decommissioning liabilities assumed in a business combination and we would incorporate the exemption for leases that is available under US GAAP.
 - More generally, for the reasons given in response to Question 1, we would exempt most non-financial items from the standard for the time being. We think there needs to be a re-debate, including consultation with constituents, about the applicability of the proposed new definition to non-financial items.

16 We agree the measurements that existing IFRS require for share-based payments, re-acquisition rights in a business combination, and financial instruments with a demand feature are inconsistent with the fair value defined in this ED. Therefore, in principle we support the exclusion of each of the three issues raised. However:

- (a) we note that the proposal is to re-label (as something other than fair value) the measurement bases to be used for share-based payments and for re-acquisition rights in a business combination, but to continue to use the label ‘fair value’ for financial instruments with a demand feature. We think all three should be re-labelled; it will be confusing for users and others to do otherwise.

- (b) while we agree that instruments with a demand feature should be excluded from the scope of the standard on fair value measurement, we hope that will be necessary only for the short-term. We think that in the longer term the IASB should reconsider the measurement of such instruments because we do not believe that the exception can be justified conceptually and we are aware that it causes problems.
- 17 More generally, having concluded earlier in this letter (a) that we do not support the application of the proposed new definition to all the non-financial items that existing IFRS requires to be measured at fair value and (b) that this concern is a 'when to' concern rather than a 'how to' concern, it follows that we also believe that many non-financial items should be scoped out of this standard. (Our reasoning is set out in our response to question 1.)
- 18 This is not to say that we believe that every reference in existing IFRS to fair valuing non-financial assets should be amended to some other current value measurement basis. Rather, we think that further work is needed before conclusions can be reached. We recognise that the IASB believes it has done that work. However, it has not laid out the results of that work for consideration by and consultation with its constituents and until that is done, constituents such as EFRAG will remain unconvinced by the conclusions the IASB has drawn. To give just one example, we think that the existing references in IFRS to fair value involve at least two different types of reference: to 'current fair value' and to 'historical fair value as a proxy for cost'. In our view these two different types of fair value requirements might require the use of different fair value definitions. The historical fair value as a proxy for cost would seem to suggest the use of an entity-specific entry value, at least in some cases, and might even require transaction costs to be added. The current fair value, on the other hand, is probably a more forward looking value that should attempt to encapsulate future cash flows. Of course, which cash flows is an important issue. We think a discussion of this and other aspects of the measurement debate are needed in order to be able to conclude definitively on whether the application of the proposed new definition should be extended beyond financial instruments.
- 19 Nevertheless, if the IASB was to decide to proceed with a broader scope, we believe IFRS 3 *Business Combinations* requires another exception to that fair value measurement principle, this time for decommissioning liabilities assumed in a business combination. We believe that applying the principles in the ED to such liabilities would not be appropriate. That is because a decommissioning liability is inherently linked to the related asset. When the asset and liability are held by the same entity, the entity may be able to prolong the use of the asset in order to defer settling the liability. Since the fair value premise of the ED assumes a hypothetical transaction for the liability alone, an entity or market participant that only had the liability would be unable to control or influence the timing of the decommissioning obligation's fulfilment. Thus the liability would seem to have similar characteristics of a stand-alone liability with a demand feature.
- 20 Finally, we note that the IASB has considered whether to exempt leases from fair value measurement. We note that leases are scoped out of US GAAP by SFAS 157, and we would urge the IASB to work jointly with the FASB to remove this difference in scope in the near term, for example as part of their joint project on leases. We think this probably means scoping such items out of the IASB's standard at least for the time being.

THE TRANSACTION

Question 3—The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions). Is this approach appropriate? Why or why not?

Summary of EFRAG's view:

- We do not support the proposal that the reference market should be the most advantageous market to which the entity has access. We think it should be the market the reporting entity would usually use to sell the asset or transfer the liability.
- 21 Paragraph 8 of the ED states that the reference market shall be the most advantageous market to which the entity has access. Paragraph 10 states that the market in which the entity would normally enter into a transaction for the asset or liability can be presumed to be the most advantageous market; and paragraph 11 in effect says it can be assumed that it is the principal market that is the most advantageous market. We recognise that, having set out a principle, the IASB is trying to provide pragmatic guidance on how to implement the principle. However, we think the result is confusing. We also note that there might be an inconsistency between the proposed guidance that the most advantageous market should be used and the requirement to follow the fair value hierarchy (which gives the highest priority to quoted prices in the most active market for identical assets and liabilities).
- 22 Furthermore, we are not persuaded that the principle in the ED is the right one. Obviously the principle chosen should be the one that will result in the most decision-useful information being provided to users. In our view that means using as the reference market the market in which the entity would normally enter into a transaction for the asset or liability. We also think this principle would be easier to understand and more straightforward to apply in practice. It would also make the helpful, but ultimately confusing, guidance in paragraphs 10 and 11 unnecessary.
- 23 Although the choice of reference market is we think particularly important where non-financial items are concerned, our comments above apply equally to financial assets and financial liabilities.
- 24 We also think it would be useful if the final standard could clarify the level at which decisions about the reference market should be taken; at the reporting entity level, at the level of the cash-generating level, or at some other level.
- (a) If the IASB accepts our suggestion that the reference market should be the market in which the entity would normally enter into a transaction for the asset or liability, we think it would probably be sufficient to explain that the objective should be to use as the reference market the market that is likely to be used in practice by the entity.
 - (b) If the IASB retains the principle in the ED (the most advantageous market that the entity can access), we think some additional guidance will be needed to make it clear that this decision can be made a lower level than the reporting entity.

Question 4—The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions). Is the description of market participants adequately described in the context of the definition? Why or why not?

Summary of EFRAG's view:

- We agree with the proposal.
- We also believe that the notion of a market participant is adequately described in the ED, although aspects of the notion could usefully be emphasised.

25 As we have already explained in our response to question 1, our understanding is that the main implications of the ED's proposal that fair value should be a market participant-based notion are that fair value should take no account of entity-specific cash flows and should be based on an arm's length transaction between knowledgeable, willing parties.

- (a) We agree that fair value should be based on "knowledgeable, willing parties" transacting at "arm's length".
- (b) Our understanding is that existing practice under IAS 39 seems to be to ignore entity-specific cash flows when estimating the fair value of financial assets and financial liabilities and users of financial statements seem to find the resulting information useful. We therefore agree that entity-specific cash flows should be ignored in fair valuing financial items. We are not persuaded that it is always decision-useful to ignore entity-specific factors when measuring non-financial items at a current value, but have concluded that that is a 'when to' concern.

It follows that we agree with the ED's proposal that fair value should be a market participant-based notion.

26 Having said that, we think the way the notion is explained in the ED could be improved. For example:

- (a) we note that there are still some concerns that the notion is explained in the ED in a complex way in that it is all about hypothetical participants on hypothetical markets carrying out hypothetical trades. The IASB could usefully remind its constituents that the objective in using the notion is primarily to ensure that future cash flows that parties, other than the reporting entity, would take into account in pricing the asset or liability in the estimate of fair value. This would address some of the concerns that have been raised about the detailed description of the market participant notion. For example, we understand that some of the IASB's constituents have raised concerns about the statement in paragraph 13(b) of the ED that market participants are presumed to be as knowledgeable as the reporting entity. Those constituents argue that the holder of an asset or liability (ie the reporting entity) usually knows more about it than someone else, so assuming away this information asymmetry means that even observable prices in active markets are imperfect estimates of fair value. We do not think that is what the IASB intends by the market participant notion, and we think that by focusing on what the objectives are in using the notion the eventual standard should be able to clarify this; and

- (b) we have heard some question the need for market participants to be “independent of each other, ie they are not related parties,” arguing that in some markets the only participants are related parties. We think it might help if the ED explained that the objective is to ensure that fair value is not affected in any way by the relationship between the two parties to the transaction.

APPLICATION TO ASSETS: HIGHEST AND BEST USE AND VALUATION PREMISE

Question 5—The exposure draft proposes that:

- (a) **the fair value of an asset should consider a market participant’s ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).**
- (b) **the highest and best use of an asset establishes the valuation premise, which may be either ‘in use’ or ‘in exchange’ (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).**
- (c) **the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).**

Are these proposals appropriate? Why or why not?

Summary of EFRAG’s view:

- We agree with the ED’s proposed approach to the ‘highest and best use’ and ‘in use v in exchange valuation premise’ issues as they apply to financial assets, financial liabilities and non-financial liabilities.
- We find the reasoning in the ED for the proposed approach on these issues to non-financial assets unconvincing, and that is one of the reasons why we are so uncomfortable about applying fair value as defined and described in this ED to non-financial items.
- However, were the proposed approach still to be applied, we would support the pragmatic presumption in the ED that, unless there is evidence to suggest otherwise, an entity’s current use of an asset is the highest and best use.

Financial assets

- 27 The IASB’s view is that financial assets do not have alternative uses, and that therefore neither the highest and best use notion nor the ‘in use’ valuation premise is relevant for such assets. We agree with this argument and conclusion.

Non-financial assets

- 28 However, we have significant difficulties with the highest and best use notion and in-use and in-exchange premises as they would apply to non-financial assets. As we mentioned in our response to Question 1, we think that entity-specific values based on how an entity intends to use an asset provide the most useful information to users wishing to make assessments about the entity’s future cash flows. In many cases, a focus on intended use will result in the same fair value

measure as the proposals in the paper. However, that will not be the case if either the reporting entity is not using the asset in its highest and best use or there are differences between what is physically possible, legally permissible and financial feasible for a market participant and what is physically possible, legally permissible and financial feasible for the reporting entity.

- 29 Our understanding is that to date there has been some diversity as to how the fair values of non-financial assets have been determined in practice. Often the fair values have been based on the intended use of the asset, but a number of other approaches have been used. It seems that the highest and best use notion and resulting valuation premises (“in-use” versus “in-exchange”) are an attempt to eliminate that diversity by making the fair value guidance operational for non-financial assets. However, our impression is that this guidance creates a fair amount of confusion on how exactly it should be applied in practice. For example:
- (a) we think there is an inconsistency in proposing on the one hand that the reference market should be entity specific (ie the most advantageous market that the entity can access) and on the other that a market-participant notion should be used. We think this inconsistency might be compounded by the material in paragraph 17 of the ED stating that what is physically possible, legally permissible and financial feasible should be assessed from a market participant’s perspective. It seems odd to us to require the reference market to be the market that is the most advantageous that the reporting entity can access, but then focuses on the uses to which market participants can put the asset. This seems complex and possibly also internally inconsistent. It is also not clear why this would result in the most useful information being provided.
 - (b) the ED requires the highest and best use to be determined from the standpoint of a market participant but at the same time states that the entity’s use of the asset would in most cases satisfy the requirement except for some entity-specific factors. It is not clear how one could determine in such circumstances whether some factors are indeed only available to the reporting entity and not to others without going through an extensive hypothetical exercise. We are concerned about what may evolve as being the burden of proof required in practice.
 - (c) it is also unclear in which cases the in-use valuation premise and in which the in-exchange valuation premise applies. The ED provides some examples, but those examples cover a narrow set of simplified situations and it is clear there is some uncertainty as to how to apply the highest and best use notion in other situations.
- 30 We think part of the problem here is that the objective behind the use of fair value measures for non-financial items has been lost sight of. Paragraph BC68 talks of benchmarking performance against the market. If that is the objective, we would have thought all entity-specific elements in the fair value exercise should be removed (including assessing the most advantageous market from the entity’s perspective). On the other hand, we think sometimes the purpose of the fair value exercise is to determine a proxy for cost and sometimes it is to provide information about future cash flows. In our view both objectives require some entity-specific factors being taken into account and the second objective probably requires the focus to be on intended use. Therefore, if fair value is to be applied to non-financial items, we think there needs to be a debate about the reasons why fair value is useful in each of the cases where existing IFRS requires fair values for

such items and, from that argumentation, it ought to be possible to develop principles that can guide preparers through the maze of possible market values.

Financial and non-financial liabilities

- 31 The IASB argues that, although an entity is sometimes able to change the cash flows from a liability by discharging the liability in different ways, those are not alternative uses so the highest and best use concept also does not apply to liabilities (regardless of whether they are financial liabilities or non-financial liabilities). We agree with this argument and conclusion.

Other comments

- 32 We also think it is important that the IASB is pragmatic in its guidance on how to estimate fair value. We are therefore pleased that the board included a very pragmatic presumption in the ED that unless there is evidence to suggest otherwise, an entity's current use of an asset is the highest and best use. We think that presumption is helpful and could even be stronger, because without it, we would be very concerned entities would have an undue burden to prove that their own use was indeed the highest and best use from a list of alternatives of which some may be difficult for entities to anticipate all the possible hypothetical uses for the asset.

Question 6—When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions). Is the proposed guidance sufficient and appropriate? If not, why?

Summary of EFRAG's view:

- We do not find this guidance particularly useful because it seems to us to oversimplify the factors that would need to be taken into account in practice and to illustrate a situation that is uncommon.

- 33 The highest and best use notion in the ED considers the asset or the group of assets and liabilities in which the asset would be used. The ED also addresses the situation where an asset is used together with other assets in a way that differs from the highest and best use. For example, land and buildings might be used for industrial use when the land would be worth more were the buildings demolished and the land used for development purposes. An implication of this guidance is that an individual asset may be worth more individually than an entire business that employs the asset.

- 34 We have two concerns about the guidance:

- (a) We think the example greatly simplifies the factors—including the costs—that would need to be taken into account by an entity in such circumstances in trying to ensure that its assets are put to their highest and best use.
- (b) It deals with an issue which, we think, is uncommon at initial recognition and deals with assets that are not usually subject to fair value remeasurements.

We think the objective of examples should be to illustrate the main principles rather than provide guidance on how to apply them in unusual circumstances.

If the guidance is to be retained, it needs to be improved to address these concerns.

APPLICATION TO LIABILITIES: GENERAL PRINCIPLES

Question 7—The exposure draft proposes that:

- (a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).**
- (b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).**
- (c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).**

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

Summary of EFRAG's view:

- We agree that the fair value of a financial liability should be based on its transfer value. (However, see our response to Question 8 concerning non-performance risk.) As previously mentioned, we do not think the ED's notion of fair value should be applied to most non-financial items.
- We do not agree that, when a financial liability has a corresponding financial asset, the fair value of the financial liability will be equal (but opposite) to the fair value of that corresponding financial asset.
- We agree that present value techniques and similar techniques should be used to estimate the fair value for which there is no corresponding asset.

Transfer value v fulfilment value

- 35 It is generally accepted that the most appropriate measure for an asset or liability is the one that results in the most decision-useful information for users. Not enough work has been done to establish what that means in practical terms, but our inclination—as we have already explained—is to believe that it probably

means that measures that reflect the circumstances in which the entity is in and the purposes for which it has acquired assets and accepted liabilities are likely to result in the most useful information. For most liabilities (both financial and non-financial) that would mean their fulfilment value because most liabilities are fulfilled, rather than transferred.

- 36 Paragraph BC69 of the ED argues that the fair value of a liability from the perspective of market participants who owe the liability is the same regardless of whether it is settled or transferred. "This is because both a settlement and a transfer of a liability reflect all costs incurred, whether direct or indirect, and that the entity faces the same risks as a market participant transferee." In other words, if one accepts that fair value is a market participant-based notion, whether transfer value or fulfilment value is used is a non-issue.
- 37 As was explained in our response to Question 1, we accept that for financial liabilities fair value is an exchange notion and is also a market participant-based notion. That means that we agree (subject to our comments about own credit risk) that the fair value of a financial liability will reflect the price that a market participant would demand to assume the liability. We share the IASB's view that this measure will generally be consistent with the liability's fulfilment value because we think a market participant that would accept the liability through transfer would base the transfer price on fulfilment.

Using the fair value of the corresponding asset as the fair value of the liability

- 38 The ED proposes that, if the liability has a corresponding asset and there is an active market for that asset (as could be the case with, for example, a debt security), the fair value of the liability will be equal to the fair value of the asset.
- 39 We have not thought greatly about this in the context of non-financial liabilities (because we do not think the ED's fair value notion to apply to such liabilities) but even in the context of financial liabilities we find this proposal somewhat inconsistent with the overall fair value framework. We understand that intuitively the fair value of a financial liability may seem like it should be the same from both the perspective of the holder of the corresponding financial asset and from the perspective of the issuer of the financial liability. However, under the fair value premise of the ED, we think market participants that might hold an entity's financial liability as a financial asset are likely to be different from market participants that might assume an entity's financial liability by transfer. We think those different market participants' views of fair value may be much different from one another because of non-performance risk which we further explain later in response to the next question. Another difference is the point made in paragraph BC75 that the fair value of a financial liability, unlike a financial asset, is not a function of marketability, but of performance. We agree with that statement in BC75 and, if the entity can settle (perform) the financial liability simply by acquiring the corresponding financial asset, we also agree with using the fair value of the corresponding financial asset as the fair value of the financial liability.

Using techniques to estimate the price that a market participant would demand

- 40 We also accept the proposal that present value techniques and similar techniques should be used to estimate the price market participants would demand to assume a financial liability for which there is no corresponding financial asset. We would also support the use of such techniques to estimate fair value where there is a corresponding asset, but no active market for that asset.

APPLICATION TO LIABILITIES: NON-PERFORMANCE RISK AND RESTRICTIONS

Question 8—The exposure draft proposes that:

- (a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfil the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).
- (b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

Summary of EFRAG's view:

- In our view, fair value of a liability should reflect non-performance risk on initial recognition only when that risk is reflected in the transaction price and fair value should reflect changes in that risk on subsequent measurement only if the liability is held for trading purposes and actively traded.
- Restrictions on an entity's ability to transfer a liability are an example of the entity-specific factors we believe need to be taken into account in measuring non-financial items if the most decision-useful information is to be provided to users.

Non-performance risk

41 As we explained more fully in our comment letter on the IASB's DP *Credit Risk in Liability Measurement*, in EFRAG's view

- (a) own credit risk should only be taken into account in the initial measurement of a liability if own credit risk is priced into the transaction that gave rise to the initial recognition of that liability. In all other circumstances it should not be included.
- (b) changes in own credit risk should be taken into account in the subsequent measurement of a liability only if it is a financial liability that is both held by the entity for trading purposes and actively traded. In all other circumstances, changes in own credit risk should not be taken into account unless and until they are 'realised' in the form of cash flows.

We refer you to that comment letter for more details, and for our reasoning.

42 We have a similar view about the inclusion of other types of non-performance risk in the measurement of a liability.

43 Bearing this in mind, it follows either that we do not agree with the definition of fair value as it applies to financial liabilities³ or that we do not support fair valuing financial liabilities in circumstances in which there is a possibility that changes in own credit risk could have a material effect on the numbers included in the financial statements. It appears, from the explanation in paragraph BC74 of the

³ We have already concluded that it should not apply to non-financial liabilities.

ED that the IASB's view is that our concern is a 'when to' concern, rather than a 'how to' concern. We are not sure we agree but, as we have said previously, it is difficult to know where to draw the line.

- 44 We have a couple of additional, more detailed, comments on this part of the ED:
- (a) The ED argues (in paragraph 29) that a creditor would not permit a debtor from transferring the obligation to another party of lower credit standing may be true because such a transfer would reduce the value of the creditor's (holder's) asset. While this may often be the case, we think the creditor's ability to prevent a transfer is actually a restriction on the obligor's ability to transfer the liability, yet the ED also states that a restriction on an entity's ability to transfer a liability to another party does not affect fair value. In our view, non-performance risk and restrictions on transferability are linked notions in some cases—as many restrictions on transferring liabilities are actually in place as a protective right of the holder of the liability from being exposed to greater non-performance risk—and therefore need to be treated alike.
 - (b) The ED also states that market participants would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price. We do not agree. As an example, in a business combination an entity often assumes another entity's debt obligations and these transactions do not always occur between parties with the same non-performance risk. We think in nearly all cases the acquirer in a business combination would value the acquired business, including the assumed debt and any other liabilities assumed on the basis of full fulfilment.

Restrictions

- 45 The ED argues that the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability, as long as that restriction is specific to the reporting entity and would not also apply to a market participant.
- 46 We have argued in this letter that the fair value notion as described in the ED is applicable only to those financial assets and financial liabilities that existing IAS 39 requires to be measured at fair value. In doing so, we have agreed that the fair value of a financial liability is a market participant based notion and is a transfer notion. The ED's proposals on restrictions are consistent with those notions.
- 47 In this letter we have also argued that the fair value notion as described in the ED is not generally applicable to non-financial items. That is partly because of the complexity in applying the proposals in the ED in such circumstances, but also because we do not think such a measure will be as decision-useful as other measures that take into account entity-specific factors. Restrictions that apply to transfers by the reporting entity but not to transfers by a market participant are an example of such entity-specific factors.

FAIR VALUE AT INITIAL RECOGNITION

Question 9—The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions). Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

Summary of EFRAG's view:

- We support the ED's proposed treatment of day one gains.

48 We have previously argued that the IASB has unduly concerned about preventing day one profits arising. We have argued that the key issue is determining what the appropriate measurement basis is in any particular circumstance. Having done that, that measurement basis should be applied regardless of whether it results in day one profits and any day one profits that arise should be recognised in the income statement immediately. However, we accept that there are a number of reasons why day one gains might occur and that recognising those gains in profit or loss on day one will not necessarily result in decision-useful information. We therefore support the proposal that whether recognition of day one gains or losses is appropriate should be determined on a standard-by-standard basis.

VALUATION TECHNIQUES

Question 10—The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples). Is this proposed guidance appropriate and sufficient? Why or why not?

Summary of EFRAG's view:

- We broadly support the guidance provided in the ED, although we have a couple of detailed concerns.

Valuation techniques

49 Generally we agree with the guidance regarding valuation techniques. We think most of these techniques are widely used in practice today and fairly well understood.

Specific guidance on markets that are no longer active

50 The ED proposes to align the IASB's application guidance for illiquid markets and distressed transactions with the recent FASB Staff Position (FSP). Although we think this guidance is compatible with the guidance in the IASB's Expert Advisory Panel Report *Using judgement to measure the fair value of financial instruments when markets are no longer active* published in October 2008, we also think that

the existing guidance in the IASB's Expert Advisory Panel Report was sufficient and appropriate. Indeed, in some ways we think it was preferable to the guidance in the ED because it is less confusing and much more principles-based. We are somewhat concerned that the more rules-based guidance contained in the ED may lead to inconsistent conclusions about whether a market is 'not' active simply because it is 'less' active than an earlier period. This may lead to greater use of unobservable inputs in fair value measurements.

- 51 We are also concerned about the interplay between paragraph 48 (which defines an active market) and paragraph B5 (which lists some factors that might indicate that a market is no longer active). It troubles us that, although the indicators as to the existence of an inactive market have been added to, the definition of an active market has not changed. Furthermore, it appears to us that the active market definition is based on just a few of the indicators of an inactive market and that, judging by paragraph 48, the other indicators appear not to be relevant to whether an active market exists. We wonder whether two paragraphs are entirely consistent.

DISCLOSURES

Question 11—The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions). Are these proposals appropriate? Why or why not?

Summary of EFRAG's view:

- We support the proposed fair value disclosures as they apply to financial instruments. We do not support the other proposed disclosures.

- 52 It is our understanding that the disclosure proposals in the ED in effect extend the disclosure requirements inserted into IFRS 7 *Financial Instruments: Disclosures* earlier in the year to non-financial items. They also propose that entities should provide certain disclosures about non-performance risk and about highest and best use.

- (a) As we have stated earlier in this letter, we do not support the application of the fair value definition and guidance set out in this ED to non-financial items. As we consider this to be a 'when to' issue, rather than a 'how to' issue, our view is that non-financial items should not be within the scope of the proposed standard. It follows from this we do not support the fair value disclosures proposed in the ED being applied to non-financial items. Instead, disclosures should be developed in the context of the measurement requirements that will apply to such assets and liabilities.
- (b) We do though support the proposal that the existing fair value disclosures for financial instruments be retained and amended slightly. More than that, we would encourage the IASB to consider extending most of the disclosures required of Level 3 measures to Level 2 measures. We suggest this because users need information about the most judgemental aspects of the measures used, regardless of whether they are Level 3 or Level 2 measures.

Having said that, we recognise that IFRS 7 applies not only to entities that have a large number of financial instruments (ie financial institutions) but to other entities as well and that extending the financial instrument disclosures will increase the burden on such entities without necessarily achieving a commensurate increase in the usefulness of the information provided. We think the solution to this lies with in the materiality test; if a specific disclosure provided by a particular type of entity does not enhance the usefulness of the information provided, that disclosure is probably not material. We think that the determination of what is material in the context of note disclosures is an area that is worthy of further study at an appropriate moment.

- (c) The proposed non-performance risk disclosures focus on how changes in non-performance risk have affected the carrying values of liabilities. As explained earlier, EFRAG is not in favour of reflecting changes in non-performance risk in the measurement of liabilities unless those liabilities are held for trading and actively traded. Furthermore, we believe that it will often be quite burdensome to estimate the impact of changes in non-performance risk on the carrying value of such liabilities, and the benefits derived from disclosing such information for such liabilities will often not be significant. For those reasons, we do not support the proposed non-performance risk disclosures.

CONVERGENCE WITH US GAAP

Question 12—The exposure draft differs from Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157. Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

Summary of EFRAG's view:

- We think the differences are generally improvements.

53 We think the differences between this exposure draft and SFAS 157 are minor improvements to the fair value measurement guidance set out in SFAS 157 because they provide greater clarity. We hope the IASB will encourage the FASB to amend SFAS 157 accordingly.

OTHER COMMENTS

Question 13—Do you have any other comments on the proposals in the exposure draft?

54 We do not have any other comments.