EFRAG

European Financial Reporting Advisory Group

xx September 2009

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

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 21 September 2009

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.

EFRAG welcomes the IASB's decision to re-define fair value and improve fair value measurement guidance. We also support the 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.

We have provided a general overview of our current position in appendix 1. In appendix 2 we have set out our detailed comments to the questions asked in the ED. However, to summarise:

- We are supportive of the fair value measurement framework described in the ED in so far as it is applied to financial assets and financial liabilities, although we have concerns related to certain aspects of the proposal. However, we do not support the application of fair value as defined and described in this ED to non-financial items.

    - 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) and to the doubts we have about whether fair value as defined would be the most useful measure in the circumstances in which existing IFRS require fair value to be used. We think this means we disagree with the ED's proposals about when to apply fair value as defined, rather than with how fair value is defined.

    - We believe the IASB should reconsider the measurement objective in the various existing IFRSs that currently require fair value measurements for non-financial items. 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.

- It follows that, for financial instruments, we agree that fair value is a market participant-based, exchange-based exit value and that, for example, the fair value of a liability should be based on its transfer value. However, we think it inappropriate to recognise changes in own credit risk by changing the amount at which the liability involved is recognised and recognising gains or losses. In our view, the fair value definition needs to be amended accordingly.

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 1
EFRAG's general position explained

Background notes for EFRAG constituents

The definition and guidance on fair value (the 'how to' issue)

1 Currently a number of IFRS require the use of fair value measures ('fair value measurement requirements'), in some cases on initial recognition only and sometimes on an ongoing basis. There is also an existing definition of 'fair value', although many of the standards that require the use of fair value measures also contain additional guidance on how fair value is to be estimated for the purposes of that standard.

2 The ED contains a new definition of fair value ("the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"). The ED also sets out guidance on how that fair value should be estimated when, for example, there is more than one market on which the item can be exchanged and how, for example, to treat factors such as apparently inactive markets, entity-specific factors and incidental costs.

3 As the ED explains, this definition and guidance address the 'how to' part of the fair value debate; in other words, the ED's proposals tell you how to determine fair value when a fair value measure is required by another standard. The ED does not itself contain requirements on the 'when to' part of the debate; ie when a fair value measure should be required.

When should fair value as defined and described be used (the 'when to' issue)

4 The IASB has carried out a standard-by-standard review of the existing fair value requirements in order to consider whether those requirements are a reference to fair value as defined and described in this ED or to some other measurement basis. Part of that review involved surveying existing practice, and part involved considering what the IASB's original intentions were when it first introduced each fair value requirement.

5 As a result of that work, the IASB is proposing that the fair value definition and guidance in the ED should replace the existing definition and the guidance in existing IFRS in all but three cases. In other words, the proposal is that the vast majority of the existing fair value measurement requirements will become requirements to measure items in accordance with fair value as defined and described in this ED.

EFRAG's general position

6 We have two fundamental concerns about the proposals in the ED:

(a) We think the proposals about reference markets and about highest and best use are unclear and internally inconsistent. As a result we think those proposals would be difficult to understand and apply.

(b) We are not persuaded that fair value as defined and described in the ED will, when applied in all the circumstances to which the fair value measurement requirements apply (other than the three exceptions mentioned earlier), will necessarily result in the most useful information being provided to users.

This is primarily because we are not persuaded that measures that take little account of entity-specific factors (such as entity specific cash flows or uses) are preferable to market participant-based measures.

These concerns are discussed more fully in appendix 2.

7 We have considered what the implications of these concerns are for the proposals in the paper:

(a) Our conclusion is that the concerns are not of major significance for the fair value measurement of financial assets and liabilities. Partly that is because we believe the notions of highest and best use generally have a less significant role to play for such items and the differences between entity-specific measures and market participant-based measures tend also to be less significant. And partly it is because we believe that existing practice when estimating the fair value of financial assets and financial liabilities is broadly in line with the proposals in the paper (the treatment of own credit risk apart).

(b) On the other hand, we think the concerns have major significance for the fair value measurement of non-financial items. Indeed, as a result of the concerns we are not persuaded that the existing fair value requirements that apply to non-financial items should be taken to refer to fair value as defined and described in the ED.

8 Having concluded that the fair value as defined and described in the ED should not be applied to non-financial items, we have then considered whether our concern is a 'when to' concern (ie we are comfortable with the definition an 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 <u>think</u> 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 be encompassed in a single tightly defined and described notion.

Appendix 2
EFRAG's detailed responses to the questions asked in the discussion paper

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?

Background notes for EFRAG constituents

Existing Definition in IFRS

1 *IAS 39 and other IFRSs currently define fair value as:*

> *The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.*

Proposed Definition

2 *The ED redefines fair value using an exit price notion as:*

> *The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

The IASB's arguments

3 *The IASB has discussed changes proposed to the current definition in the following terms:*

> *The definition of fair value refers to an arm's length transaction. An arm's length transaction is one between parties that do not have a particular or special relationship that makes prices of transactions uncharacteristic of market conditions. The transaction is presumed to be between unrelated parties, each acting independently.*
>
> *Thus, although the two definitions use different words, the concept is the same – fair value is a market-based measure in a transaction between unrelated parties.*

4 *Similar to the existing definition, the proposed definition retains the exchange notion for assets, and assumes the exchange transaction is not a distressed or forced sale. However, the board believes the proposed definition improves upon the existing definition by:*

(a) *specifying whether the entity is buying or selling the asset;*

(b) *replacing the ambiguous reference to 'settling' a liability with a reference to 'transferring' it; and*

(c) *explicitly addressing the measurement date.*

5 *While the new definition uses an exit price notion, the board believes that its original intention when requiring the use of fair value might in some cases have been to require use of an entry price. Nevertheless, the board considered that using a definition based on an exit price would not be inconsistent with the measurement objective within those standards. In BC28 the ED states:*

As a result of the standard-by-standard review, the Board concluded 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. Therefore, the Board considered it unnecessary to make a distinction between current entry price and current exit price in IFRSs with a market-based measurement objective (ie fair value), and decided to define fair value as a current exit price.*

** Some have questioned the assertion that entry and exit prices are equal in those situations, citing bid-ask spreads as a potential difference between entry and exit prices in the same market. In reaching its conclusion, the Board acknowledged that such a difference could exist but attributed any such difference to transaction costs, which are not included in the price when measuring fair value.*

EFRAG's response

EFRAG view

- We 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 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.
- In our view our concerns about the wider application of the definition are a 'when to' issue, rather than a 'how to' issue. It follows that we have decided to support the proposed definition (subject to our concerns about own credit risk), but also to argue that it should be applied more narrowly than is proposed.

6 The 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 settlement 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.

To agree that this is the proper definition implies agreement with each of these elements.

7 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. EFRAG has sought to do this in the discussion below by taking into account what the existing fair value definition says about the notion of fair value.

Exchange notion v in use/settlement notion

8 The first element 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 settlement 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.

9 However, the position is not as clear for liabilities because the existing definition refers to a settlement notion, and it would appear that settlement could take the form of fulfilment or of transfer. (The proposal that the definition should focus on the transfer value of a liability, rather than its fulfilment value or settlement value, is discussed further in Question 7.) We accept that, when financial liabilities are measured under IAS 39 at fair value, it is a transfer notion that is being used.[1] 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.

Market participant-based notion v entity-specific notion

10 The second element 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 fair value should be estimated without taking into account cash flows that would not be taken into account by someone other than the holder of the asset or liability. Furthermore, 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".

11 We agree that fair value should be based on "knowledgeable, willing parties" transacting at "arm's length". 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 will result in the most decision-useful information being provided to users.

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[1] That is not to say that we agree that the fair value of a financial liability should be its transfer value, because we do not agree that an entity's own credit risk should normally be included in a liability's fair value. We discuss this further in our response to Question 8.

Exit notion v entry notion

12 Finally, 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 as a non-issue; in other words, when there are perceived to be differences between entry and exist price that is actually because prices from different markets are being compared.

13 We believe that this reasoning 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 seems to be inconsistent with 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) Bid-offer spreads apart, the IASB is probably correct when it states 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. However, an entity is not always able to both buy and sell in a particular market, so it will often not be indifferent to whether IFRS requires it to use an exit price or an entry price from a particular market.

14 Having said that, 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

15 It follows from this that, when 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—except that, as discussed later, we think fair value should be defined to exclude own credit risk. In other words, we accept the 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).

16 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 or apply. We also think that some of the guidance is internally inconsistent.

(b) It is also because, as explained above, we are not persuaded that the fair value of a non-financial liability is necessarily its transfer value, we are not persuaded that the most useful current value information about non-financial items is provide by ignoring entity-specific cash flows, and we think the IASB's reasoning for concluding that fair value is an exit notion is flawed. In other words, 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 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.

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, for many non-financial assets and liabilities there are not and never have been 'active' markets. For these items we think the application of the fair value framework is difficult and is unlikely to achieve the objectivity that some seek. Indeed, because non-financial assets and liabilities are mostly based on level 3 of the fair value hierarchy, we think the measurement results that follow are in fact approximations of values which, if labelled 'fair value', might imply a level of precision that does not exist and that may be unhelpful.

(c) In spite of some helpful presumptions in the ED (for example, in paragraphs 10 and 11), we are also concerned about the effort necessary to substantiate all the notions (highest and best use, market participant assumption) for each asset and liability. This may be far more burdensome in a business combination that may involve numerous measurements and we are not convinced the benefits exceed the costs. Attempting to think of hypothetical market participants and then attempting to arrive at hypothetical assumptions those hypothetical participants might use results in a very hypothetical exercise. We think this will not only lead to application difficulties, but we also do not think the results should be used in measurements. Even in a business combination an entity uses many of its own expectations and assumptions in order to arrive at the consideration for the transaction. Those amounts are not hypothetical and we generally think financial reporting using those entity-specific amounts provides users with more useful information.

17 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. We think it follows that the concerns we have about applying the proposed new definition of fair value to non-financial items are probably not concerns about the definition itself (ie 'how to' concerns); rather, they are concerns about when the definition is applied (ie 'when to' concerns). Furthermore, as we can 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 be encompassed in a single tightly defined and described notion. Accordingly, in our response below to Question 2,

we have argued for non-financial items to be excluded from the scope of the Fair Value Measurement standard.

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?

Background notes for EFRAG constituents

18 *Some have expressed concerns that a new definition may alter the measurement intended in existing IFRSs that use fair value. To address those concerns and as part of the Fair Value Measurement Project, the IASB undertook a standard-by-standard review of fair value measurements currently required or permitted in IFRSs. The purpose of this review was to determine whether the IASB or its predecessor intended each fair value measurement basis to be a 'current exit price'. The alternative measurement basis intended would be a 'current entry price'.*

19 *The following IFRSs either use fair value at initial recognition or use fair value frequently in discussion or both*[2] *and were part of the standard-by-standard review:*

(a) *IFRS 3* Business Combinations – *initial recognition at fair value and subsequent measurement depends on other IFRSs.*

(b) *IFRS 5* Non-current Assets Held for Sale and Discontinued Operations – *initial recognition at fair value and subsequent measurement at fair value*

(c) *IAS 16* Property, Plant and Equipment – *initial recognition at cost and subsequent measurement at either fair value or cost*

(d) *IAS 17* Leases – *initial recognition at fair value and subsequent measurement at cost*

[2] Source: IASB Staff Paper from July 2008 meeting.

(e) *IAS 19* Employee Benefits *(for plan assets) - initial recognition at fair value and subsequent measurement at fair value*

(f) *IAS 38* Intangible Assets - *initial recognition at fair value and subsequent measurement at fair value (only if quoted market price) or cost*

(g) *IAS 39* Financial Instruments: Recognition and Measurement - *initial recognition at fair value and subsequent measurement at fair value or amortised cost*

(h) *IAS 40* Investment Property - *initial recognition at cost and subsequent measurement at fair value or cost*

(i) *IAS 41* Biological Assets - *initial recognition at fair value and subsequent measurement at fair value*

20 *There were certain uses of fair value found in IFRS as a result of the IASB's standard-by-standard review where the board did believe the intent was to use a measure that was inconsistent with an exit price notion, and therefore the board proposes to address these issues by either amending the IFRS or including in the standard resulting from this ED a scope exception. Those uses are as follows:*

(a) *The measurement guidance in IFRS 2 for equity instruments granted is fair value based, but not fair value because the effect of service and performance conditions as well as reload features are not taken into account when estimating fair value. The ED proposes therefore to amend IFRS 2* Share-based Payment *by replacing the term 'fair value' with 'market-based value' and by adding a definition of 'market-based value'.*

(b) *The board also tentatively concluded IFRS 3's measurement guidance for reacquired rights is not consistent with the measurement guidance in the proposed ED because the transaction is a settlement rather than a fair value measurement. Again, the ED would amend the term used in IFRS 3 for reacquired rights.*[3]

(c) *IAS 39 states that the fair value of a financial liability with a demand feature shall not be less than the amount payable on demand discounted from the first date the amount can be required to be settled. The board believes that this does not meet the proposed definition because the measurement assumes settlement at the earliest possible date rather than assumptions used by market participants in measurement and addresses the issue by providing a scope exception.*

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[3] Paragraph BC 309 of IFRS 3R states "The 2005 Exposure Draft did not include guidance on determining the fair value of a reacquired right. Some constituents indicated that determining that value is a problem in practice, and the boards agreed that the revised standards should include guidance on that point. To be consistent with the requirement for determining the useful life of a reacquired right, the boards concluded that the fair value of the right should be based on the remaining term of the contract giving rise to the right. The boards acknowledge that market participants would generally reflect expected renewals of the term of a contractual right in the fair value of a right traded in the market. The boards decided, however, that determining the fair value of a reacquired right in that manner would be inconsistent with amortising its value over the remaining contractual term. The boards also observed that a contractual right transferred to a third party (traded in the market) is not a **reacquired** right. Accordingly, the boards decided that departing from the assumptions that market participants would use in measuring the fair value of a reacquired right is appropriate."

EFRAG's response

EFRAG view

- We agree that all the exemptions proposed are needed.
- However, we would add other exemptions:
  - In particular, as we do not believe that a sufficiently strong case has been made for applying the proposed new definition of fair value to non-financial items, we would exempt all non-financial items from the standard for the time being.
  - We would also exempt certain decommissioning liabilities assumed in a business combination.

21 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.

22 More generally, having concluded earlier in this letter that (a) we do not support the application of the proposed new definition to non-financial items and that (b) this concern is a 'when to' concern rather than a 'how to' concern, it follows that we also believe that all non-financial items should be scoped out of this standard. There are two main reasons for this, which we noted earlier:

(a) The first is that we find the proposals in the ED simply too confusing and too difficult to understand when non-financial items are involved, and thus difficult to 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.

(b) The second reason is that we do not believe the use of such a measurement basis will provide as much decision-useful information as certain of the alternative current value measurement bases available.

23 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 cost 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.

24 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 settlement. Thus the liability would seem to have similar characteristics of a stand-alone liability with a demand feature.

Question to EFRAG's constituents

25 Are you aware of other fair value measurements in IFRS that should be addressed by amendment or scope exception?

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?

Background notes for EFRAG constituents

26 *The ED proposes that the reference market should be the most 'most advantageous market'. The DP* Fair Value Measurements *proposed that the focus should be on the 'principal market', and that the 'most advantageous market' was to be used only in the absence of a 'principal market'.*

(a) *The DP described the principal market as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability.*

(b) *The DP described the most advantageous market as the market in which the reporting entity would sell the asset or transfer the liability with the price that maximises the amount that would be received for the asset or minimises the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s).*

27 *The board explains the development of its thinking in the following terms in the ED:*

BC39 Respondents generally agreed with the Board's preliminary view, but noted that an entity is most likely to enter into a transaction in the most advantageous market. Some respondents also suggested that a fair value measurement should reflect the price in the market in which an entity usually enters, or expects to enter, into a transaction. They asserted that this is likely to be the most advantageous market.

BC40 The Board agreed with these respondents and noted that most entities aim to maximise profits. Therefore, the exposure draft proposes that a fair value measurement should assume that the sale of an asset or transfer of a liability takes place in the most advantageous market to which the entity has access. To mitigate concerns about search costs, the Board clarified that an entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market. Moreover, it is presumed that the entity would normally enter into a transaction for the asset or liability in the most advantageous market.

28 *The ED also makes it clear that the reference market should be the most advantageous market that the reporting entity has access to. And, in determining which market that is, transaction and transportation costs should be taken into account.*

29 *Finally the ED explains, in paragraph 10, that "the market in which the entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market" and, in paragraph 11, that, "in the absence of evidence to the contrary, an entity may assume that the principal market for the asset or liability is the most advantageous market, provided that the entity can access the principal market".*

<u>EFRAG's response</u>

EFRAG view • We support the proposal that the reference market should be the most advantageous market.

30 EFRAG supports the proposal that as to the reference market that should be used for the purposes of estimating fair value. We think it is preferable because businesses will endeavour to position themselves so as to be able to access the most advantageous market, so the proposal will generally mean entities can use the market they usually use. For practical purposes, we think it would be better still if the reference market was simply the market in which the entity would normally enter into a transaction for the asset or liability, because identifying that market would be easier still.

31 For that reason, we also support the presumption included in the ED that the market in which the entity would normally enter into a transaction is the most advantageous market, as we think this presumption will be very helpful in applying the proposed IFRS.

32 Having said that, we do think an aspect of this proposal is inconsistent with other aspects of the ED. (This is part of the confusion we noted earlier in our response to Questions 1 and 2.) It would appear from the explanations in the ED that the notion of a market participant is fundamental to the fair value principle. Paragraph BC68 seems to suggest that a key advantage of using the market participant notion is that it in effect benchmarks the entity's actual performance against the market. Yet the ED proposes use of a reference market that seems to be entity specific (because it is the most advantageous market that the entity has access to). Either the ability to benchmark is important, in which case some other reference market should be used, or it is not important—in which case the reasoning in BC68 is not valid.

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?

Background notes for EFRAG constituents

33 *The ED emphasises that a fair value measurement is a market participant-based measurement rather than an entity-specific measurement. It describes market participants and provides guidance in determining the assumptions they would apply in valuing assets and liabilities in paragraphs 13 and 14 of the ED. Paragraph 13 states:*

Market participants are buyers and sellers in the most advantageous market for the asset or liability that are:

(a) *independent of each other, ie they are not related parties (as defined in IAS 24 Related Party Disclosures);*

(b) *knowledgeable, ie they are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability;*

(c) *able to enter into a transaction for the asset or liability; and*

(d) *willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.*

34 *Paragraph 14 states:*

The fair value of the asset or liability shall be measured using the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, an entity need not identify specific market participants. Rather, the entity shall identify characteristics that distinguish market participants generally, considering factors specific to:

(a) the asset or liability,

(b) the most advantageous market for the asset or liability and

(c) market participants with whom the reporting entity would enter into a transaction in that market.

<u>EFRAG's response</u>

EFRAG view
• We agree with the proposal.
• We also believe that the notion of a market participant is adequately described in the ED.

35 As already explained, we support the use of the market participant notion in the definition of the fair value of a financial instrument, but are not persuaded that it is appropriate to ignore entity-specific factors when non-financial items are involved.

36 However, putting that aside, EFRAG thinks that in general the notion of a market participant is adequately explained in the ED. It seems to us that in many ways it is a similar notion to that envisaged by the current fair value definition's references to "knowledgeable, willing parties in an arm's length transaction", and those references have proved broadly satisfactory and capable of reasonably consistent application.

37 We think an aspect of that notion is perhaps worth trying to explain more clearly. 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 distorted in any way by the relationship between the two parties to the transaction.

38 We have found it useful, when considering the market participant notion, to remind ourselves 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.

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?

Background notes for EFRAG constituents

39 *As paragraph (a) of the question makes clear, the ED proposes that 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. For this purpose the uses to be considered are those that are physically possible, legally permissible and financially feasible at the measurement date; and, in determining what is possible etc, the physical characteristics, legal restrictions and income and cash flow considerations taken into account should be those that a market participant would take into account. The ED states that it is not relevant to a decision as to an asset's highest and best use whether the reporting entity intends to use the asset in that way or differently. On the other hand, it also states that a reporting entity "need not perform an exhaustive search for other potential uses [to the intended use] if there is no evidence to suggest that the current use of an asset is not its highest and best use."

40 *An asset's highest and best use will involve the asset either being used on a standalone basis or being used together with other assets and perhaps liabilities. The ED requires both possibilities to be considered. The ED goes on to explain that:*

(a) *if the highest and best use of the asset is on a standalone basis, its fair value will be the price that would be received in a current transaction to sell the asset to a market participant who would use the asset on a standalone basis. This is known as the in-exchange valuation premise.*

(b) *if the highest and best use of the asset is being used together with other assets and perhaps liabilities, its fair value will be the price that would be received in a current transaction to sell the asset to a market participant who has access to those other assets and liabilities. This is known as the in-use valuation premise.*

41 *The ED explains (in paragraph BC60) that the in-use valuation premise is consistent in the context of fair value defined with an exit price:*

Many respondents to the discussion paper perceived conflicts between the in-use valuation premise and the exchange notion encompassed within the definition of fair value. The Board considered those comments and concluded that there is no conflict. If the highest and best use of an asset is 'in use', market participant buyers would willingly pay a price that reflects that use and market participant sellers would not willingly accept a lower price. Thus, the in-use valuation premise considers the cash flows that market participants would expect to generate from using the asset. Therefore, the exposure draft clarifies that an exit price considers a market participant's ability to generate economic benefit either by using an asset or by selling it to a third party.

42 *The ED also makes it clear that the in-use valuation premise and value-in-use are not the same thing.*

43 *The ED states that that the highest and best use notion is not used for <u>financial</u> assets and that they should be fair valued using the in-exchange valuation premise. Paragraph BC51 explains the IASB's reasoning:*

In the Board's view, financial assets do not have alternative uses. For example, although entities sometimes repackage or modify financial assets for securitisations, those activities change the characteristics of the financial assets so that they become different assets. The objective of a fair value measurement is to measure the asset that exists at the measurement date.

44 *Similarly, the ED states that the highest and best use notion is not relevant for liabilities. Paragraph BC52 of the ED explains the IASB's reasoning:*

The Board concluded that the highest and best use concept does not apply to liabilities. An entity might be able to change the cash flows from a liability by discharging it in different ways (eg fulfilment in the normal course of business, immediate settlement with the counterparty or immediate transfer to another party). However, the Board does not view those as alternative uses. Moreover, although an entity might have entity-specific advantages or disadvantages that enable it to fulfil a liability more or less efficiently than other market participants, those entity-specific factors do not affect fair value.

EFRAG's response

EFRAG view

- We also agree that the 'in use' valuation premise does not apply to financial assets or liabilities for the reasons stated in the ED.
- We find the reasoning in the ED for the proposals in this area 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 it 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.

45 As explained above, the IASB's view is that financial assets do not have alternative uses, and that therefore the highest and best use notion is not relevant for such assets; they should be fair valued using the in-exchange valuation premise. The IASB also 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. We agree with these arguments and conclusions.

46 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 provides the most useful information to users about 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.

47 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 commented earlier in this letter that we thought there was an inconsistency in thinking 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 stand point 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 in-use valuation premise and in which 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 determine how to apply the highest and best use notion in other situations.

48 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. As we have mentioned earlier, paragraph BC68 talks of benchmarking performance against the market. We criticise that argument in this letter but, if that is indeed the principle, 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 sometime 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.

Other comments

49 We also think it is important that the IASB is pragmatic in its guidance on how to estimate fair value. Therefore, even though we have significant concerns about the application of the highest and best use principle to non-financial items, we are still 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?

Background notes for EFRAG constituents

50 *The ED suggests that the highest and best use of an asset may differ from its current use. This may be the case where an entity uses an asset with other assets and liabilities as a group and the entity may apply an 'in-use' valuation premise, yet the individual asset may be valued higher using an 'in-exchange' valuation premise because other market participants may have a higher and better alternative use for the individual asset.*

51 *The ED then addresses the situation where the fair value of the assets under the alternative use differ (exceed) from the value of the assets assuming their current use. The ED provides guidance to address this situation in paragraphs 20 and 21:*

ED20 In some cases, an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset. For example, an entity might operate a factory on a parcel of land even though the highest and best use of the land is to demolish the factory and build residential property. In such cases, the fair value of the asset group has the following components:

(a) *the value of the assets assuming their current use. This value differs from fair value when the current use of the assets is not their highest and best use. However, this value reflects all other factors market participants would consider when determining the price for the assets.*

(b) *the amount by which the fair value of the assets differs from their value in their current use (ie the incremental value of the asset group).*

ED21 An entity shall recognise the incremental value described in paragraph 20(b) together with the asset to which it relates. Using the example in paragraph 20, the incremental value relates to the entity's ability to convert the land from its current use as an industrial property to its highest and best use as a residential property. Accordingly, the fair value of the land comprises its value assuming its current use plus the incremental value described in paragraph 20(b). The amount attributed to the factory reflects its current use as noted in paragraph 20(a). An entity shall account for the assets in accordance with the IFRSs applicable to those assets.

52 *The ED uses an example to illustrate this guidance in IE5 through IE8:*

IE5 An entity acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. As an industrial property (the current use), the indicated value of the land and factory is CU100,000 and CU60,000, respectively. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, the entity determines that the land currently used as a site for a factory could be developed as a site for residential use (for high-rise apartment buildings).

IE6 The highest and best use of the land would be determined by comparing (a) the value of the land as currently developed for industrial use ('in use') and (b) the value of the land as a vacant site for residential use, considering the costs of demolishing the factory and other costs necessary to convert the land to a vacant site ('in exchange'). In this situation, the highest and best use of the land would be to develop high-rise apartment buildings ('in *exchange'). As a residential property, the indicated fair value of the vacant site is CU300,000 after considering the costs to demolish the factory and other costs of conversion to a vacant site.*

IE7 Because the current use of the land differs from its highest and best use, the fair value of the asset group (land and factory) has two components: (a) the value of the assets assuming their current use as industrial property and (b) the amount by which the fair value of the assets differs from their value in their current use. The amount in (b) is determined by subtracting the current-use value of the land and factory (CU160,000) from the fair value of the vacant site (CU300,000).

IE8 The entity measures the land at CU240,000. This is the current-use value of the land (CU100,000) plus the incremental value of the land (CU140,000) that relates to the ability to convert the land from its current use to its highest and best use. The entity measures the factory at CU60,000. The entity accounts for the assets in accordance with the IFRSs applicable to those assets.

53 *In this example, the land on a stand-alone basis has an alternative higher fair value than the asset group under its current use. The guidance provides that the total fair value of the asset group should still be based on the highest and best use, in this case, CU300,000 so the incremental fair value is allocated to the land since that individual asset has a higher fair value from an alternative use. This guidance addresses not individual asset that may have a higher and better use, but a group of assets. In BC54 the ED suggests this guidance was requested by users:*

Users of financial statements asked the Board to consider how to account for assets when their highest and best use within a group of assets is different from their current use by the entity. For example, the fair value of a factory is linked to the value of the land on which it is situated. The fair value of the factory would be nil if the land has an alternative use that assumes the factory is demolished. The Board concluded that measuring the factory at nil would not provide decision-useful information when an entity is using that factory in its operations. In particular, users would want to see depreciation on that factory so that they could assess the economic resources consumed in generating cash flows from its operation.

EFRAG's response

EFRAG view

- We do not agree with this guidance and believe it should be omitted from the final standard.

54 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.

55 We do not find this guidance particularly useful for two reasons:

(a) It deals with an extreme example, and therefore a narrow issue. We think the objective of the examples should be to illustrate the main principles not provide guidance on how to apply them in extremely unusual circumstances. The effect is also to distract rather than enlighten.

(b) We think in any case 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.

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?

Background notes for EFRAG constituents

56 *As question (a) makes clear, the fair value of a liability is based on the liability's market participant-based transfer value, rather than its settlement value. The board's reasoning (as set out in paragraph BC68) is that this enables the entity' performance in settling the liability to be benchmarked against the market:*

> *In many cases, an entity might not intend to transfer its liability to a third party. For example, an entity might have advantages relative to the market that would make it more beneficial for the entity to fulfil the liability using its own internal resources. A fair value measurement provides a market benchmark to use as a basis for assessing an entity's advantages or disadvantages in performance or settlement relative to the market. Therefore, when a liability is measured at fair value, the relative efficiency of an entity in settling the liability using its own internal resources appears in profit or loss over the course of its settlement, and not before.*

57 *One of the concerns that has been raised in the past about basing the fair value of a liability on its transfer value is that that might involve including in fair value amounts (such as profit for example) that would not be included in a settlement value. However, paragraphs BC69 and BC70 of the ED explain that the IASB believes that the fair value of a liability from the perspective of a market participant who owes the liability will be the same regardless of whether it is settled or transferred.*

That 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.

When determining the settlement amount, an entity will bear in mind that it does not have perfect knowledge about the timing and amount of the cash outflows. It will also have regard to its desire to earn a profit on all of its activities, including fulfilling the obligation. Similarly, when determining the amount to demand to assume a liability, market participant transferees will bear in mind that they do not have perfect knowledge about the timing and amount of the cash outflows and its desire to earn a profit on fulfilling the obligation. As a result, the Board concluded that similar thought processes are needed to estimate both the amount to settle a liability and the amount to transfer that liability.

58 *The ED explains that in many cases there will not be an observable market price for the transfer of a liability and in such cases:*

(a) *if there is an active market for the corresponding asset, the observed price in that market will represent the fair value of the liability;*

(b) *in other circumstances the fair value of the liability should be determined by estimating, using present value and similar techniques, the price that market participants would demand to assume the liability.*

EFRAG's response

EFRAG 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.)

- We do not agree that, when a liability has a corresponding asset, the fair value of the liability will be equal (but opposite) to the fair value of that corresponding 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 settlement value v fulfilment value

59 Although it is surely not contentious that the most appropriate measure for an asset or liability is the one that results in the most useful information for users, little work seems to have been done to establish what that means in practical terms. Our inclination though—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 that will mean their fulfillment value.

60 However, we accept the general premise in the ED that fair value is an exchange notion, and it seems to us that it follows that in theory the fair value of a liability will be reflect the price that a market participant would demand to assume the liability. However, as we have already stated, we do not believe that fair value as defined in this ED should apply to non-financial liabilities.

<u>Using the fair value of the corresponding asset as the fair value of the liability</u>

61 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.

62 We find this proposal somewhat inconsistent with the overall fair value framework. We understand that intuitively the fair value of a liability may seem like it should be the same from both the perspective of the holder of the corresponding asset and from the perspective of the issuer of the liability. However, under the fair value premise of the ED, we think market participants that might hold an entity's liability as an asset are likely to be different from market participants that might assume an entity's 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 liability, unlike an 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 liability simply by acquiring the corresponding asset, we also agree with using the fair value of the corresponding asset as the fair value of the liability.

<u>Using techniques to estimate the price that a market participant would demand</u>

63 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 liability for which there is no corresponding 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?

Background notes for EFRAG constituents

64 *As part (a) of the question explains, the ED states that the fair value of a liability reflects the effect of the risk that an entity will not fulfil an obligation. This non-performance risk includes, but may not be limited to, an entity' own credit risk. Thus, "when measuring the fair value of a liability, an entity shall consider the effect of its credit risk (credit standing) and any other risk factors that might influence the likelihood that the obligation will not be fulfilled." The board's thinking here is explained as follows:*

BC73 The exposure draft proposes that a fair value measurement assumes that the non-performance risk related to a liability (ie the risk that an entity will not fulfil an obligation) is *the same before and after its transfer. Those who might hold the entity's obligations as assets would consider the effect of the entity's credit risk and other risk factors when pricing those assets. Accordingly, the exposure draft proposes that a fair value measurement for a liability should consider the effect of the reporting entity's own credit risk (credit standing) and other non-performance risk factors.*

BC74 Few respondents to the discussion paper questioned the decision-usefulness of reflecting the non-performance risk of a liability at initial recognition. However, some questioned the decision-usefulness of doing so after initial recognition, because they argued that it would lead to counter-intuitive and potentially confusing reporting (ie 'gains' for credit deterioration and 'losses' for credit improvements). The Board understands that these concerns are strongly held, but concluded that addressing them is beyond the scope of this project. The purpose of this project is to define fair value, not to determine when to use fair value. A measurement that does not consider the effect of an entity's non-performance risk is not a fair value measurement. The Board plans to consider these concerns in a separate document that it is developing for public comment.

That "separate document" is the discussion paper Credit Risk in Liability Measurement that the IASB issued for comment on 18 June 2009.

65 *The ED also states that, for the purpose of estimating fair value, non-performance risk should be assumed to be the same before and after the transfer of the liability. Paragraph 29 explains this further:*

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. For example, a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor (debtor) if those terms reflect the transferor's lower credit standing.

66 *The ED also states that the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability.The board's argument to exclude restrictions is made in BC75:*

The fair value of a liability, unlike an asset, is not a function of marketability, but of performance [ie a function of the requirement to fulfil the obligation]. A market participant transferee will be required to fulfil the obligation (ie settle the obligation with the counterparty or otherwise fulfil the obligation) and would take that into account when determining the price it would demand to assume the liability from the entity. In other words, the market participant transferee, like the reporting entity, must perform to be relieved of the obligation.

<u>EFRAG's response</u>

EFRAG view

- We believe it is inappropriate to recognise changes in own credit risk by changing the amount at which the liability involved is recognised and recognising gains or losses.
- We have considered the possibility that this concern arises from the circumstances in which the fair value definition is applied to liabilities, rather than from the definition itself, but have concluded that our concerns lie with the definition.

Non-performance risk

67 As we explained in our [draft] comment letter on the IASB's DP *Credit Risk in Liability Measurement*, in EFRAG's view it is not appropriate to recognise changes in own credit risk by reducing (or increasing) the amount at which the liability involved is recognised in the statement of financial position and recognising gains (or losses) in the income statement or in Other Comprehensive Income. In our view, such accounting introduces information that is not relevant into the financial statements and, by obscuring information that is relevant, makes the financial statements less understandable. We understand that it can be argued that recognising the effects of changes in own credit risk in the financial statements makes the information more comparable, but it is our understanding from the discussions we have had with users that that particular comparability is not valued by them.

68 Bearing this in mind, it follows either that we do not agree that the fair value of a liability should reflect changes in own credit risk or that we do not support fair valuing 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.

69 We note that it would appear, from the explanation in paragraph BC74 of the ED, to be the IASB's view that our concern is a 'when to' concern, rather than a 'how to' concern. In other words, our concern has nothing to do with the definition of fair value. However, we do not agree that the fair value measurement of a liability should reflect changes in non-performance risk. On the other hand, we agree that, upon issuance of a financial liability instrument and regardless whether there is an active market, the transaction price or amount paid by the holder of a liability and received by the issuer would reflect non-performance risk.

70 Furthermore, we also accept that, when an issuer of a liability can readily settle the liability by purchasing it from the holder in an active market, the settlement value of the instrument as a liability and its fair value as an asset might be the same, and that that value would again include non-performance risk.

71 However, the ED states that the fair value of a liability should be based on a transfer notion. Although we agree that non-performance risk is included in the fair value from the perspective of those that hold an entity's liability as an asset—because it is a risk factor that may impact the holder's return on the asset—we think the perspective of holders of those instruments and the perspective those obligated to settle those instruments are fundamentally very different from one another. In considering an instrument only as a liability, market participants that an entity might be able to transfer the liability to would then be obligated to ultimately settle the liability at a later date in full. Unlike a holder of an asset that is exposed to a return risk on an asset, the entity that is obligated to settle a liability normally must settle the full amount or is normally at risk of far more than just a lower return. Often entities that do not settle obligations in full are at risk of continuing as a going concern as creditors may have the ability to force a liquidation of the entity. The nature of this risk, and thus its impact on fair value, is in our view fundamentally different.

72 As a result of this reasoning, we can still accept a transfer notion for financial liabilities provided the transfer notion is linked to fulfilment of the liability. In applying this reasoning to a transfer notion, if an entity has the ability to settle a liability by acquiring the corresponding asset (ie the value that includes an entity's own credit risk), it follows that a hypothetical transferee of the liability may value the liability the same way because the liability could be settled by acquiring the corresponding asset. On the other hand, if there is no ability to settle by acquiring

the corresponding asset, a hypothetical transferee would value the liability on the basis of fulfilling the obligation as we noted in Question 7 and is implied by paragraph BC75. For non-financial liabilities, this would almost always be the case.

Other comments

73 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.

74 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 settlement.

Restrictions

75 We agree that the fair value of a liability should not be adjusted for restrictions mainly for the reason stated in BC75. We think the view of a liability containing restrictions for both the reporting entity and a potential market participant transferee would be similar in that both would view the liability as something that required performance in fulfilling the obligation.

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?

Background notes for EFRAG constituents

76 *The ED explains that, although conceptually entry and exit prices are not the same, in practice in many cases an entry price will equal the exit price when they relate to the same asset on the same date in the same form in the same market.*

77 *The ED then requires that an entity shall consider factors specific to the transaction and the asset or liability and states that for example, the transaction price is the best evidence of the fair value unless:*

(a) *The transaction is between related parties.*

(b) *The transaction takes place under duress.*

(c) *There is a difference in the unit of account, e.g. the asset was acquired together with some other rights or privileges.*

(d) *The most advantageous market of the entity is different from that where the entity acquired the asset or incurred the liability.*

78 *If the fair value on initial recognition is different from the transaction price, the ED requires recognition of day one gain or less unless the relevant IFRS requires otherwise.*

79 *The following standards in IFRSs require fair value measurement on initial recognition and therefore would be subject to the requirements of a standard on the fair value measurement when it is finalised: IFRS 3 Business Combinations, IAS 17 Leases, IAS 19 Employee Benefits (for plan assets), IAS 39 Financial Instruments: Recognition and Measurement and IAS 41 Agriculture.*

EFRAG's response

EFRAG view

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

80 We agree that day one gains or losses are a direct consequence of a current exit price measurement objective. We also support determining whether recognition of day one gains or losses is appropriate 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?

Background notes for EFRAG constituents

81 *The ED retains the same valuation techniques previously presented in the DP using three alternative approaches to estimate the price that would take place between market participants in an orderly transaction:*

(a) *Market approach. The market approach uses prices or multiples and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business).*

(b) *Income approach. The income approach uses valuation techniques to convert future amounts (eg cash flows or income and expenses) to a single present amount.*

(c) *Cost approach. The cost approach is based on the amount that would currently be required to replace the service capacity of an asset (often referred to as current replacement cost).*

82 *Inputs to the valuation techniques are the assumptions that market participants would use in pricing the asset or liability. Inputs are either observable or unobservable. The ED uses a hierarchy of level 1, 2 and 3 inputs. The reporting entity determines which approach is appropriate for the asset or liability in the circumstances and maximises the use of relevant observable inputs and minimises the use of unobservable.*

83 *The ED includes application guidance for markets that are not active and transactions that are not orderly similar to the guidance recently added to US GAAP.*

EFRAG's response

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

Valuation techniques

84 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

85 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, it 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.

86 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 have been added, 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, and that the other indicators appear from paragraph 48 not to be relevant to whether an active market exists.

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?

Background notes for EFRAG constituents

87 *The ED proposes to require the disclosures that were in the DP as well as some additional disclosures. The following disclosures were added:*

(a) *significant transfers into or out of level 1 and level 2 of the hierarchy;*

(b) *if reasonably possible alternative assumptions for a level 3 input were changed and cause a significant change in fair value, that fact and the effect that change would have;*

(c) *the fair value hierarchy for each class of assets and liabilities disclosed but not measured at fair value in the statement financial position;*

(d) *for liabilities measured at fair value after initial recognition (i) the amount of the change attributable to non-performance risk (ii) how the amount was determined (iii) and the difference between the liability's carrying amount and the amount required to satisfy the obligation; and*

(e) *when an asset's highest and best use differs (i) the value of the asset assuming current use (ii) the difference assuming highest and best use and (iii) the reasons why the entity uses the asset different from the highest and best use.*

88 *The disclosures will substitute the disclosure requirements for financial instruments which are currently set out in IFRS 7 Financial Instruments Disclosures. These disclosures will also apply to non-financial assets and liabilities.*

89 *The ED also proposes to amend IAS 34 to require certain interim disclosure of fair value measurements for financial instruments.*

<u>EFRAG's response</u>

EFRAG view

- We support the proposed disclosures, with one exception.

90 We generally support the disclosure requirements of the ED as the recent financial crisis has emphasised the need for disclosures pertaining to fair value measurements. However, for the reasons stated in our response to Question 6, we do not support the disclosure requirement for assets that are not employed using their highest and best use.

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?

Background notes for EFRAG constituents

91 *BC110 summarises the differences between SFAS 157 and the ED and states:*

As noted in paragraph BC7, the Board's starting point in developing the exposure draft was SFAS 157. The Board believes that the proposals in the exposure draft are largely consistent with SFAS 157, as amended, except in the following respects:

(a) *Scope. Unlike SFAS 157, the proposed IFRS would apply to leasing arrangements. However, it would not apply to the measurement of reacquired rights in a business combination or financial liabilities with a demand feature. (Paragraph BC29)*

(b) *Reference market. Unlike SFAS 157, which assumes the transaction to sell the asset or transfer the liability takes place in the principal market (or, in the absence of a principal market, the most advantageous market), the exposure draft proposes that an entity should assume that the transaction takes place in the most advantageous market to which the entity has access. (Paragraphs BC37–BC41)*

(c) *Highest and best use. Unlike SFAS 157, the exposure draft proposes presentation requirements for circumstances when an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset. (Paragraphs BC54 and BC55)*

(d) *Blockage factors. Unlike SFAS 157, which specifies the unit of account for financial instruments measured within Level 1 of the fair value hierarchy, the draft IFRS is silent on the unit of account for financial instruments. IAS 39 specifies the unit of account for financial instruments as the individual instrument. This applies to all three levels of the fair value hierarchy. (Paragraphs BC34 and BC35)*

(e) *Day 1 gains or losses. Unlike SFAS 157, which implicitly requires the recognition of day 1 gains or losses even if the fair value measurement uses unobservable inputs, the exposure draft defers to the relevant standards for the asset or liability (eg IAS 39 for financial assets and financial liabilities) to determine whether to recognise the gain or loss. (Paragraphs BC76–BC79)*

(f) *Valuation premise and financial instruments. Unlike SFAS 157, the exposure draft states explicitly that the in-use valuation promise is not relevant to financial assets. (Paragraph BC57)*

(g) *Measurement of liabilities. Unlike SFAS 157, which includes limited guidance on the measurement of liabilities, the exposure draft proposes a framework for measuring a liability using the same methodology that the counterparty would use to measure the fair value of a corresponding asset. The FASB is developing a staff position to clarify the measurement of liabilities at fair value in accordance with SFAS 157. If finalised, the proposal is expected to be largely consistent with the proposals in the draft IFRS. (Paragraphs BC67–BC72)*

(h) *Measurement of equity instruments. Unlike SFAS 157, the exposure draft discusses how to apply the exit price notion to equity instruments measured at fair value.*

(i) *Wording changes. The IASB staff is preparing a marked-up text showing wording differences between the exposure draft and SFAS 157, as amended. The marked-up text will be made available on the IASB's website.*

EFRAG's response

EFRAG view
• We think most of the differences represent improvements, with one exception.

92 We think the differences between this exposure draft and SFAS 157 are, with one exception, enhancements to the fair value measurement guidance because they clarify the application of the standard. However, as mentioned in response to Question 6, we do not think the additional guidance for when an entity uses an asset together with other assets in a way that differs from the highest and best use is necessary.

OTHER COMMENTS

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

93 We have some minor drafting points for the exposure draft:

(a) Paragraph 27 of the ED addresses the situation where there is an active market between parties that hold debt securities as assets and paragraph 28 addresses the situation where there is no corresponding asset. The ED does not address the situation where there is a corresponding asset, but the market for that asset is not active.

(b) We find paragraph 35 of the ED confusing because it states:

> Although conceptually entry prices and exit prices are different, in many cases an entry price of an asset or liability will equal the exit price …

We note that in BC28 the board concluded on seemingly conceptual grounds that current entry and current exit prices are the same.

(c) We also find confusing the words "for example" in the second sentence of paragraph 36 in the ED:

> For example, the transaction price is the best evidence of the fair value of an asset or liability at initial recognition unless...

(d) We note that in paragraph D 32, which is a consequential amendment to the relevant guidance in IAS 39, the word "normally" is used:

> The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price.