Jonathan Faull
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

20 January 2012

Dear Mr Faull

Adoption of IFRS 13 *Fair Value Measurement*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on IFRS 13 *Fair Value Measurement* (IFRS 13), which was issued by the IASB on 12 May 2011. It was issued as an Exposure Draft in May 2009 and EFRAG commented on that draft.

The objective of IFRS 13 sets out a single IFRS framework for measuring fair value and provides comprehensive guidance on how to measure the fair value of both financial and non-financial assets and liabilities. IFRS 13 applies when another IFRS requires or permits fair value measurement or disclosures about fair value measurements, thus it does not set out requirements on "when to" apply fair value measurement.

IFRS 13 becomes effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted, however entities shall disclose that fact.

IFRS 13 includes consequential amendments to IFRS 9 *Financial Instruments*, which has not yet been endorsed in the EU. Therefore, those consequential amendments are not addressed in this endorsement advice and will be considered together with the related requirements in IFRS 9.

EFRAG has carried out an evaluation of IFRS 13. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports IFRS 13 and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that it:

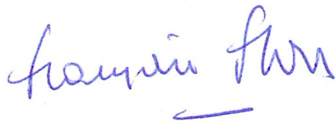
- Is not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IFRS 13 and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely



Françoise Flores
EFRAG Chairman

APPENDIX 1
BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the IFRS 13 *Fair Value Measurement* (IFRS 13).

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of IFRS 13 meet the criteria for EU endorsement?

1 EFRAG has considered whether IFRS 13 *Fair Value Measurement* meets the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that IFRS 13:

(a) is not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered, based only on evidence brought to its attention by constituents whether it would be not conducive to the European public good to adopt IFRS 13.

Relevance

2 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

3 EFRAG considered whether IFRS 13 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

4 The objective of IFRS 13 is to provide guidance on *how to* measure the fair value and not to re-open the debate on whether the fair value is an appropriate measure for certain items or how changes in the fair value should be accounted for. EFRAG notes that the debate about any possible, future IASB proposal to extend the use of fair value in IFRS financial statements would benefit from fair value being clearly

defined. Furthermore, as explained below, in reaching its views, EFRAG specifically considered the views of those constituents who believe that the IASB should have reconsidered *when* measurement at fair value would be appropriate. In performing the initial assessment of IFRS 13, EFRAG considered how its requirements would be applied to various assets, liabilities and own equity instruments that are subject to fair value measurement or disclosure, and whether the new fair value measurement guidance would result in the provision or omission of the relevant information about those assets, liabilities and own equity instruments to the users. In particular, EFRAG considered assets, liabilities and own equity instruments, which fall in the scope of the following standards:

(a) IFRS 1 *First-time Adoption of International Financial Reporting Standards* – assets and liabilities subject to fair value measurement or disclosure requirements under IFRS; deemed cost for property, plant and equipment, investment property and intangible assets.

(b) IFRS 3 *Business Combinations* – identifiable assets acquired and liabilities assumed; non-controlling interest in the acquiree; pre-existing relationships; consideration transferred; contingent consideration; previously-held equity interest in the acquiree.

(c) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* – non-current assets held for sale and assets forming part of a disposal group within the scope of the measurement requirements.

(d) IAS 16 *Property, Plant and Equipment* – property, plant and equipment acquired in an exchange for a non-monetary asset; assets accounted for under the revaluation model.

(e) IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* – non-monetary assets.

(f) IAS 36 *Impairment of Assets* – measurements that have some similarities with fair value but are not fair value, such as value in use in IAS 36 are scoped out of IFRS 13. However, the measurement of fair value (less costs to sell) is within the scope of IFRS 13.

(g) IAS 38 *Intangible Assets* – intangible assets acquired in an exchange for a non-monetary asset or in a business combination (relates to IFRS 3); assets accounted for under the revaluation model.

(h) IAS 39 *Financial Instruments: Recognition and Measurement* – financial assets and liabilities.

(i) IAS 40 *Investment Property* – investment property.

(j) IAS 41 *Agriculture* – biological assets.

5 In performing the initial analysis, EFRAG focused on the impact of the changes introduced to the fair value measurement guidance, primarily defining the fair value as an exit price, the new concepts of the principal market and the highest and best use (for non-financial assets), more comprehensive disclosure requirements and guidance for measuring liabilities and equity instruments, for which no quoted price is available.

6 The results of EFRAG's assessment are presented below in the following order:

(a) Financial assets, financial liabilities and own equity instruments;

(b) Non-financial assets – initial recognition only;

(c) Non-financial assets – subsequent measurement;

(d) Non-financial liabilities.

<u>Financial assets, financial liabilities and own equity instruments</u>

7 EFRAG's assessment is that guidance in IFRS 13 is consistent with the fair value measurement guidance currently included in IAS 39; and the changes introduced are not expected to affect the current practice. Therefore, the relevance of information provided to the users of financial statements about financial instruments, in general, should not be affected.

8 However, an issue that has been identified as potentially causing some concerns about the relevance of information about financial assets, financial liabilities and own equity instruments resulting from the application of IFRS 13 relates to the question of whether the principal market should be determined from a group perspective or a sub-group perspective.

9 In measuring the fair value of a specific asset or liability, IFRS 13 requires referring to the principal market for that asset or liability. Paragraph 17 of IFRS 13 defines the principal market as a market, in which an entity would normally enter into a transaction to sell a specific asset or to transfer a specific liability. Some read IFRS 13 as requiring determining the principal market from a group perspective. To support their view, they refer to the concept of a reporting entity, which is being developed by the IASB, and to example 6 included in the illustrative guidance to IFRS 13. Different entities within a group may operate in different markets, and similar assets or liabilities held by different entities within the group may be traded on different principal markets. If the principal market is determined only from the group perspective, then for those assets and liabilities, which are regularly traded on a different market, it would not result in relevant information.

10 EFRAG notes that the term "entity" is not defined in IFRS 13 and that the IASB has not finalised *The Reporting Entity* chapter of *The Conceptual Framework for Financial Reporting*. Additionally, paragraph 19 of IFRS 13 specifies that the principal market should allow for differences between different entities and businesses within those entities. EFRAG also notes that example 6 in the illustrative guidance to IFRS 13 considers a similar but different scenario with one asset, which can be sold on two different markets.

<u>Non-financial assets – initial recognition only</u>

Exit price

11 When considering non-financial assets acquired in a business combination under IFRS 3 or a non-monetary grant under IAS 20, some argue that the objective of the fair value should be to depict the entry price to provide users with relevant information about the acquisition transaction. However, EFRAG agrees with the IASB's conclusion reflected in paragraph BC44 of IFRS 13 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. The difference between an entry price and an exit price is usually the result of:

(a) comparing an entry and an exit in different markets, rather than comparing an entry and an exit in the same market;

(b) comparing two different assets, when the characteristics of the assets are not taken appropriately into account (e.g., unused car and a three-day old car) or when bundled assets are being analysed (e.g., a second-hand car sold by a car dealer with an implicit or explicit warranty versus a second-hand car sold by a private individual); and

(c) inappropriate unit of account (e.g., if an entity bought an asset or group of assets and now has to account for them in a grouping that is different from when they bought it: valuing assets acquired by an “asset stripper” together with the acquirer’s business).

Therefore, EFRAG’s assessment is that defining the fair value as an exit price, in itself, is not expected to cause any issues in relation to the relevance of the information about non-financial assets acquired in a business combination or non-monetary grants.

12 In relation to property, plant and equipment and intangible assets acquired in a non-monetary exchange, EFRAG notes that IAS 16 and IAS 38 require measuring such items at the fair value of the asset given up. Therefore, EFRAG does not believe that defining the fair value as an exit price will introduce any change in practice of determining fair value for such assets, and will not affect the relevance of the resulting information.

Principal market as an exit market

13 In measuring the fair value of a specific asset or liability, IFRS 13 requires that reference is made to the principal market for that asset or liability. The principal market is presumed to be the market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability (i.e., the exit market for the entity). If an entity is able to buy and sell a particular item in the same market, then the discussion about different markets is irrelevant. However, when an entity is not able to sell a particular item in the market, in which it was acquired (i.e., the exit and the entry market for that item are different), some argue that using the entry market for measuring the fair value of a non-financial asset acquired in a business combination or a non-monetary grant would result in more relevant information to the users.

14 One of the examples, which is often used to argue the differences between the entry and the exit markets, is fair value of inventory acquired in a business combination. Some argue that if the fair value of the acquired inventory were determined by reference to the entry market, then it would not include a profit allowance for the selling effort of the acquirer. However, it would be different if the fair value were determined by reference to the exit market. Including the profit allowance for the selling effort, which is still to be made in the future, would not result in relevant information about the acquired inventory. EFRAG notes that guidance on measuring finished goods acquired in a business combination, which is included in paragraph B35(f) of IFRS 13, states that the fair value measurement should reflect the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. That is, the

allowance for the selling effort is excluded from the fair value of inventory acquired. EFRAG's assessment is that guidance in IFRS 13 on measuring inventory acquired in a business combination is consistent with the current practice.

Highest and best use from the market participant's perspective

15 A fair value measurement of a non-financial asset under IFRS 13 considers a market participant's ability to generate economic benefits by using that asset in its highest and best use or by selling it to another market participant who will use the asset it its highest and best use. The highest and best use is determined from the perspective of a market participant, even if the entity intends a different use. However, there is a presumption that the entity uses the asset in its highest and best use unless there is evidence to suggest otherwise.

16 IFRS 13 presumes that an entity and market participants hold the same views on the highest and best use of the asset. Furthermore, it presumes that there is no difference between what is physically possible, legally permissible and financially feasible for the entity and for a market participant. However, some argue that entity-specific values reflecting the entity's intentions regarding the use of an asset provide the most relevant information to users wishing to make assessments about the entity's future cash flows.

17 As stated in paragraph BC71 of IFRS 13, the IASB concluded that in many cases it would be unlikely for an asset's current use not to be its highest and best use after taking into account the costs to convert the asset to the alternative use. Therefore, in such cases the market-based valuation input reflecting the use of the asset would not differ from the entity-specific valuation input. EFRAG notes that an entity-specific value would differ from a market-based value when the entity uses a non-financial asset in a way that is different from its highest and best use. IFRS 13 requires disclosure on why the non-financial asset is being used in a manner that differs from its highest and best use. Such information is relevant for users, as it draws their attention to the existence of different options for using a particular asset and to the business decisions made by management, if management decides to use the asset differently from its highest and best use. Therefore, the relevant information for users would be provided via disclosures.

Non-financial assets – subsequent measurement

Exit price

18 IFRS 5 requires measuring a non-current asset or a disposal group classified as held for sale at the lower of its carrying amount and fair value less cost to sell. The measurement provisions of IFRS 5 also apply to other assets in a disposal group except for assets in the scope of IAS 12 *Income Taxes*, IAS 19 *Employee Benefits*, IAS 39, IAS 40, IAS 41 and IFRS 4 *Insurance Contracts*. EFRAG's assessment is that the fair value of a non-current asset held for sale (or of another asset in the disposal group that is in the scope of the measurement guidance of IFRS 5), which reflects an exit price in the entity's principal market or the most advantageous market, would provide users of financial statements with the relevant information for their analysis.

19 IAS 36 Impairment of assets defines *fair value less costs to sell* as the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. EFRAG's assessment is that an asset's or cash-generating unit's fair value reflects

an exit price in the entity's principal market or the most advantageous market, and would provide users of financial statements with relevant information for their analysis.

20 When considering property, plant and equipment and intangible assets accounted for under the revaluation model, EFRAG believes that the focus on the *future* cash flows (either from the use or from the sale of the assets), which is reflected in the exit price, would result in the relevant information for the users' analysis.

Highest and best use from the market participant's perspective

21 EFRAG's initial analysis in relation to the highest and best use valuation premise, as applied to property, plant and equipment and intangible assets accounted for under the revaluation model, is similar to the analysis in relation to non-financial assets measured at fair value on initial recognition (refer to paragraphs 15 to 17 above).

Investment property

22 EFRAG's assessment is that IFRS 13 does not introduce significant changes compared to the fair value guidance that was included in IAS 40, except that IAS 40 restricted future capital expenditure from being included in a fair value measurement. That explicit restriction has not been carried forward to IFRS 13. As the objective of fair value measurement is still to reflect the characteristics of the asset (including its condition) at the measurement date, the deletion of the guidance from IAS 40 should not result in a change in practice. Hence, IFRS 13 would not affect relevance of information provided to the users about investment property.

23 EFRAG notes that valuers typically determine the fair value of investment property under construction[1] by reference to the fair value of the completed investment property, which is adjusted for the costs to complete the project, and profit and risk. Therefore, EFRAG believes that IFRS 13 does not introduce significant changes, which could affect the relevance of the information about investment property under construction.

Biological assets

24 EFRAG's assessment is that IFRS 13 does not introduce significant changes to the fair value guidance that was included in IAS 41; therefore, IFRS 13 would not affect relevance of information provided to the users about biological assets.

Non-financial liabilities

Market participant view

25 When measuring fair value, IFRS 13 requires considering only those characteristics of an asset or liability, which market participants would take into account when pricing that asset or liability at the measuring date, i.e., entity-specific inputs are not considered. EFRAG believes that entity-specific values in relation to non-financial liabilities assumed in a business combination would provide the most useful information to users wishing to make assessments about the entity's future cash

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[1] For example, refer to Guidance note 17 published by the International Valuations Standards Council.

flows. If the information held by market participants is identical to the information held by the entity, then market-based inputs do not differ from the entity-specific inputs used for the valuation. In those cases, the relevance of information about non-financial liabilities assumed in a business combination would not be affected. However, if entity-specific inputs used for the valuation differed from market-based inputs, then some information, which could be relevant for the users' analysis, might be omitted but this is attributable to IFRS 3 *Business Combinations,* not to IFRS 13.

Restrictions on transfers

26 When measuring the fair value of a liability or an entity's own equity instruments, IFRS 13 does not allow including a separate input or an adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the item. Some argue that restrictions on transfers are an example of the entity-specific factors that need to be taken into account in measuring non-financial items if the most decision-useful information is to be provided to users. EFRAG notes that paragraph 45 of IFRS 13 states that restrictions on transfers are already implicitly or explicitly included in the other inputs used for measuring the fair value; thus, no *separate* adjustment is needed. Therefore, EFRAG believes that this requirement would not affect the relevance of information resulting from the application of IFRS 13.

Conclusion

27 EFRAG's assessment is that IFRS 13 satisfies the relevance criterion.

Reliability

28 EFRAG also considered the reliability of the information that will be provided by applying IFRS 13. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

29 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness. In EFRAG's view, IFRS 13 does not raise any significant issues concerning freedom from material error and bias.

30 IFRS 13 requires maximising the use of observable inputs in determining the fair value and providing comprehensive disclosures when inputs are not observable (so-called Level 3 inputs). In addition, changes introduced in the fair value measurement guidance (i.e., exit price, principal market, highest and best use) mainly impact comparability and relevance of information, but do not significantly affect the reliability of it.

31 IFRS 13 provides guidance on measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased. Some argue that the requirement to produce fair value information may not be appropriate if there has been a significant decrease in the volume or level of activity for a particular asset or liability. However, EFRAG notes that IFRS 13 does not govern *when* fair value information is required, but only *how* fair value should be determined. In addition, some argue that information may not be reliable if entities operating on the same market arrive at different conclusions on whether or not there has been a significant decrease in the volume or level of activity for a particular asset or liability. EFRAG notes that paragraphs B37 to B44 of IFRS 13 introduce guidance that enhances the

reliability of information even when the volume or level of activity for an asset or a liability has significantly decreased. Also, specific disclosures are intended to help users better understand how entities incorporate in the measurement of fair value the effects of significant decreases in the volume or level of activity for an asset or a liability. EFRAG notes that, following the request made by the G20 to address the main accounting issues raised by the financial crisis, IFRS 13 incorporates the recommendations of the IASB's Expert Advisory Panel. While IFRS 13 does not resolve the discrepancies observed in the sovereign debt crisis, it does not stand in the way of EFRAG recommending IFRS 13 for endorsement. Although the additional disclosure requirements in IFRS 13 are helpful, EFRAG thinks it would be worth investigating the matter to determine whether a supplementary standard setting effort could further improve the standard.

32 Therefore, EFRAG's assessment is that IFRS 13 does not cause any significant issues in relation to reliability of information about assets or liabilities subject to fair value measurement or disclosure requirements, and satisfies the reliability criterion.

Comparability

33 The notion of comparability requires that *like* items and events are accounted for in a cons*ist*ent way through time and by different entities, and that unlike items and events should be accounted for differently.

34 EFRAG has considered whether IFRS 13 results in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

35 The objective of IFRS 13 is to set out a *single* source of guidance for measuring fair value of both financial and non-financial assets and liabilities. It consolidates guidance, which had previously been dispersed across standards, and removes inconsistencies. The more prescriptive guidance on determining fair value is expected to result in standardisation of the method for determining fair values, because it reduces the range of assumptions that entities can reasonably be expected to make. EFRAG believes that, in general, IFRS 13 is expected to improve comparability of information provided to the users.

36 However, some argue that guidance in paragraphs 70 and 71 of IFRS 13 in relation to bid-ask spread may potentially affect comparability of information, as it is less prescriptive than IAS 39 which would require the use of either the bid or ask price. However, the requirement to use the price within the bid-ask spread that is most representative of fair value, results in a consistent application of the principles underlying IFRS 13. Therefore, EFRAG believes that any differences in measurement should reflect differences in the underlying substance.

37 EFRAG's assessment is that IFRS 13 satisfies the comparability criterion.

Understandability

38 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

39 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

40 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRS 13 is understandable, is whether that information will be unduly complex.

41 EFRAG did not identify any issues, which could indicate that IFRS 13 introduces any new complexities that may impair understandability. Therefore, EFRAG's overall initial assessment is that IFRS 13 satisfies the understandability criterion.

True and Fair

42 EFRAG has initially decided that the information resulting from the application of IFRS 13 would not be contrary to the true and fair view principle.

European public good

43 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IFRS 13.

Conclusion

44 For the reasons set out above, EFRAG has decided that IFRS 13 satisfies the technical criteria for EU endorsement; and EFRAG should, therefore, recommend its endorsement.