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Dear Sir David

Measuring and disclosing fair value of financial instruments that are no longer active

The draft document 'IASB Expert Panel: Measuring and disclosing the fair value of financial instruments in markets that are no longer active' published on 16th September for comment by 3rd October is the first output from the IASB under the three short term projects being pursued at the request of the Financial Stability Forum. The other two concern: the accounting and disclosure of off balance sheet instruments; and disclosures concerning valuations, methodologies and the uncertainty associated with valuations. We understand that progress is being made on these and that proposals intended to fulfil the FSF remit will be discussed when the Board meets on 2nd October.

The 16th September draft document published by the expert panel was prepared specifically to address issues concerning the valuation of financial instruments in illiquid markets. The draft guidance published by the expert panel appears limited in scope and can be supported insofar as it goes. But against the backdrop of events since the publication of the draft on 16th September - or the issues raised in response to the consultation 'Reducing Complexity in Reporting Financial Instruments' - there is a case for the IASB doing more to fulfil its remit from the FSF to address issues in relation to fair value measurement in illiquid markets.

We believe the IASB should set itself the task of amending IAS 39 in key areas within its remit from the FSF. This would include the review of issues concerning the classification of instruments and, in particular, the immediate deletion (or suspension) of paragraph 50 of IAS 39 prohibiting reclassification from trading.

Status of the document

A further question relates to the status of the guidance, expectations on the part of regulators and the way in which it will be acted upon by audit firms. Our comments below on the guidance provided on valuation and disclosures on financial instruments and on disclosures when markets are no longer active are made on the basis of the guidance being intended to enhance current guidance. It would be a matter of concern if organisations other than the IASB sought to interpret the guidance or to give it a status not intended by the IASB.

Active versus inactive markets

The draft document is limited in scope in that it provides guidance within the existing terms of IAS 39 and appears not to break new ground. Its principal contribution is to provide additional guidance on judgements about valuation and there are elements of the commentary that we support. We agree, in particular, with the view that *“entities need to put more work into the valuation process to gain assurance that the transaction price represents the best evidence of fair value or to determine the adjustments to transaction prices that are necessary to measure the fair value of the instrument.”*

The question, however, is whether the transaction price observed represents fair value. It would seem to us to underplay the very real issues that arise in an inactive market to conclude the guidance with the statement that *“regardless of the level of market activity a current transaction price for the same or similar instrument normally provides the best evidence of fair value.”* While this may be the case, it nevertheless overlooks the difficulties that are known to have arisen as a result of the rigidity surrounding the fair value hierarchy adopted in the US under SFAS 157. In our view the preceding paragraph places a more appropriate emphasis on the relevance of current transaction prices in saying that *“it is not appropriate to ignore transaction prices when measuring fair value and a transaction price in the same or a similar instrument should be considered in the assessment of fair value.”*

The table given on page 28 providing a comparative analysis of the fair value hierarchies used for disclosure in IFRS 7 and measurement in SFAS 157 is helpful but limited in nature.

Fundamental value versus fair value

We do not necessarily disagree with the conclusions drawn on the question of fundamental value and its relationship to fair value. As the draft document observes: *“Transaction prices continue to reflect fair value and cannot be ignored, even in a market crisis. Accordingly, a value measured using a ‘fundamental value approach’ might not represent an estimate of a current transaction price’.*

In reproducing the above statement from the draft document we have changed the emphasis since the more important point we feel is that in a depressed inactive market the management’s estimate of future cash flows is likely to be highly relevant in the estimation of current fair value. Of course other factors may be relevant, but the bottom line is that subject to credit considerations an instrument’s intrinsic value to an entity is likely to be determined by its earnings flow if the current market price produces a lower return. This is akin to the principles in IAS 36 where, in accordance with the notion that the entity will act rationally, the recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use. In contrast, exit price fair value measurement at times of severe market distress and illiquidity may result in the financial statements for a financial institution being prepared on a basis contrary to the going concern assumption. The IASB should consider whether it can provide more guidance on this issue

Fast track amendments to IAS 39

While we do not disagree with the expert panel in its analysis of fundamental v fair value measurement, we nevertheless believe that the IASB should consider making fast track changes to IAS 39 based on points raised in the 150 comment letters received in recent weeks in response to its discussion paper ‘Reducing Complexity in Reporting Financial Instruments’. It would be entirely in keeping with the remit set by the FSF for the IASB to set itself the task of making rapid progress on amendments to IAS 39. Issues to be addressed could include:

- Reclassification between the four principal categories for financial instruments: trading; available-for-sale; held-to-maturity; and loans and receivables.
- The removal of some of the rules associated with individual categories.
- Simplification of the hedge accounting rules.

Reclassification between categories

We believe that the IASB should act immediately to eliminate the prohibition on reclassification from trading. It is clear that instruments are being held in trading books that are no longer trading in nature. We see a case, at least, for permitting transfers to the available-for-sale category providing such transfers are made on the basis of fair value on the date of reclassification and on a fully disclosed basis. This would require nothing more than deleting paragraph 50 of IAS 39 and would place IFRS on more of an equivalent footing to US GAAP. We can see no reason why the IASB could not proceed to make this change without delay, particularly as this is an area in which IFRS adopts an anti-abuse approach not replicated in US GAAP.

There may also be a case for permitting reclassification to held-to-maturity, though this may require consideration of additional issues, some of which are touched upon below. Providing such transfers take place at fair value on the date of reclassification and on a fully disclosed basis the change could enhance financial reporting.

Removal of some of the rules associated with individual categories

The 'reducing complexity' paper reflects on the possible removal of one or more of the principal categories for financial instruments. We believe that reducing complexity would be better served by the IASB addressing some of the unnecessary rules and anomalies that create significant barriers to accounting for financial instruments in a logical and systematic way. In particular:

- The tainting rules in the held-to-maturity category that have served only to make this category unusable in circumstances where use of the category may otherwise have been in keeping with the reasons why an instrument is held in the first place. Appropriate disclosures should instead be put into place. The inability to hedge interest rate risk in respect of H-T-M instruments is also an issue.
- The impairment rules in respect of equity instruments held as available-for-sale. There are two rules that need to be addressed here: first, the basis on which impairment is calculated, which extends beyond the credit element of the perceived loss; second, the inability to reverse impairments through the P&L.

Simplification of the hedge accounting rules

Many of the proposed measures that would result in the simplification of the hedge accounting rules have been under discussion for some time and we believe the IASB should proceed to implement the more straightforward of these. Potential measures would include:

- The proposal to permit the inclusion of a fallback method for effectiveness testing, reflecting the fact that risk management needs to be applied flexibly if it is to respond to changing market circumstances.
- Replacing retrospective effectiveness testing with a prospective qualitative test.
- Greater reliance generally on principles given that actual ineffectiveness is recognised in earnings immediately.

While the response to the discussion paper raises issues that will require considerable further analysis and investigation, we also believe that the IASB should make an early public statement to the effect that it has no intention in the medium term of proceeding with its objective that all financial instruments should be measured at full fair value.

Review of conclusions drawn on 'fair value measurements'

We are also of the view that the current market turmoil also puts into sharp contrast the Board's proposals under its discussion paper 'Fair Value Measurements' and the very significant concerns expressed by many commentators – which to large degree, and by its own admission, the Board has chosen to ignore. We believe therefore that a fundamental review of the conclusions being drawn under this project should now be undertaken including the reliance on a market participant view and the use of exit price as the measure of fair value.

We would ask that this letter be shared with the Board and also taken as a supplementary response to the discussion paper 'Reducing Complexity in Reporting Financial Instruments'.

Yours sincerely

A handwritten signature in black ink that reads "Paul Chisnall". The signature is written in a cursive, flowing style.

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