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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

SAC Meeting:	**November, London**
Project:	**Fair Value Measurement** ***(Agenda Paper 5a)***

Comment letter summary

INTRODUCTION

1 The purpose of this paper is to provide a summary of the comments received on the *Fair Value Measurements* discussion paper. It is not a comprehensive list.

SUMMARY OF COMMENTS RECEIVED

2 Nearly all respondents agree that the project is needed. They think that establishing a single source of fair value measurement guidance would improve IFRSs. They also view the discussion paper as an important step toward convergence. Many respondents are concerned that divergence between US GAAP and IFRSs in fair value measurement guidance would be very difficult to explain to users. They encourage the IASB and the FASB to work together to resolve any differences.

3 However, many respondents are concerned that, because SFAS 157 was issued so recently, the FASB might be reluctant to change it, and they wonder whether the boards will be able to reach the objective of convergence if the IASB does not accept the Statement as it currently stands. Furthermore, many respondents interpret the

issuance of a discussion paper based on a US standard as an indication that the IASB is adopting US GAAP.

4 Most respondents focus on how fair value would apply generally. However, some of the focus on a single aspect of fair value measurement, such as its application to financial instruments. Those who focus on financial instruments generally agree with FASB Statement of Accounting Standards No. 157 (SFAS 157) as it applies to financial instruments, but point out that they might not agree with it for non-financial assets and liabilities.

Issue 1. SFAS 157 and fair value measurement guidance in current IFRSs

Q1	**In your view, would a single source of guidance for all fair value measurements in IFRSs both reduce complexity and improve consistency in measuring fair value? Why or why not?**

5 Many respondents find it difficult to have a discussion about *how* an exit price should be measured without first discussing *when* it would be used in IFRSs. The proposal in the discussion paper to perform a standard-by-standard review to determine whether each incidence of 'fair value' in IFRSs represents an exit price or another measurement basis seems to have caused confusion. Respondents found it hard to comment on the application of an exit price to items that might or might not be measured as such. They think it is necessary to know what will be measured before deciding how it should be measured. Many also think the objectives of financial reporting need to be determined before commenting on whether an exit price is appropriate for IFRSs. Because of this, nearly half of the respondents believe the fair value measurement project should not be completed before the conceptual framework project. That staff notes that the conceptual framework project will develop a framework and foundation on which *future* decisions can be made rather than directly clarifying current IFRSs.

6 Because fair value is used more extensively in IFRSs than in US GAAP,[1] some respondents question whether a principles-based standard can be developed that is

[1] The staff notes that the requirement in IFRS 3 and SFAS 141 *Business Combinations* to measure at fair value the assets acquired and liabilities assumed in a business combination effectively means that the breadth of the fair value requirements of both GAAPs is the same, at least for initial recognition in a business combination.

able to provide sufficient guidance on the broad range of assets, liabilities and transactions recorded at fair value under IFRSs without being overly complicated.

Q2	**Is there fair value measurement guidance in IFRSs that you believe is preferable to the provisions of SFAS 157? If so, please explain.**

7 Many respondents think the guidance in IFRSs is preferable to that in SFAS 157 because each Standard addresses the issues pertinent to its own fair value measurement (eg IFRS 2 *Share-based Payments*, IFRS 3 *Business Combinations*, IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 40 *Investment Property* and IAS 41 *Agriculture*).

8 However, many prefer some of the requirements of SFAS 157 to those in IFRSs, although these comments might stem from the fact that IFRSs currently do not have a unified standard on fair value measurement. Some think SFAS 157 is principles-based and that it describes valuation concepts that are consistent with valuation practice.

Issue 2A. Exit price measurement objective

Q3	**Do you agree that fair value should be defined as an exit price from the perspective of a market participant that holds the asset or owes the liability? Why or why not?**
Q4	**Do you believe an entry price also reflects current market-based expectations of flows of economic benefit into or out of the entity? Why or why not? Additionally, do you agree with the view that, excluding transaction costs, entry and exit prices will differ only when they occur in different markets? Please provide a basis for your views.**

9 Although many respondents agree with the definition of an exit price, they believe it describes only one aspect of fair value measurement (and that it relates mainly to financial instruments). They think many fair value measurements in IFRSs are closer to an entry price than an exit price and think a ‘one size fits all’ approach might not be appropriate.

10 Many respondents think SFAS 157 presumes that active, liquid markets exist for all assets and liabilities and that perfect market information will always be available from which to base fair value measurements. They think these presumptions hold for most financial instruments, but not for many non-financial assets (eg specialised assets) and most, if not all, non-financial liabilities (eg performance obligations). They are

concerned that using an exit price for all measurements currently labelled ‘fair value’ in IFRSs would not consider situations in which an asset or liability is used in the business or when there is not an active market. They think an entry price or another measurement basis (eg a form of ‘value in use’) might reflect better these circumstances, particularly when the fair value measurement is based on level 3 inputs. Furthermore, some think of an exit price as a liquidation value or fire sale even though SFAS 157 refers to an orderly transaction. Some respondents in the insurance industry note that the European Union’s proposal for Solvency II uses the concept of an exit price in the valuation of insurance liabilities.

11 Many respondents think a current entry price is just as relevant as a current exit price. They think the objective should be not only to indicate the inflows of economic benefit, but the economic resources actually incurred or spent by the entity. They think an entry price is more appropriate than an exit price circumstances such as:

a when there is a transaction price for the asset or liability;

b when fair value is used as a substitute for historical cost or when no historical cost information is available;

c when the item will not be measured subsequently at fair value; or

d when the asset will be held or used in the business.

12 However, some respondents disagree with the use of an entry price, mainly on the basis that it reflects the circumstances specific to the entity.

13 Many respondents agree that entry and exit prices will differ only when they occur in different markets, excluding transaction costs. However, some respondents think differences can arise even within the same market when the market is not perfectly competitive. For example:

a when a market does not have sufficient liquidity and activity, prices will not have reached an equilibrium level between buyers and sellers and arbitrage opportunities will exist.

b when there is a difference in the level of information available to the market participants (ie when asymmetric information exists), such as different competitive advantages, expectations of futures cash flows and appetites for risk. In other words, they think the entry price and exit price could differ because the expectations of the entity would be considered in the entry price, but not in the exit price.

Q5	**Would it be advisable to eliminate the term 'fair value' and replace it with terms, such as 'current exit price' or 'current entry price', that more closely reflect the measurement objective for each situation? Please provide a basis for your views.**

14 Many respondents consider 'fair value' to be a family of measurement bases and recommend replacing that term with more descriptive terms such as 'current exit price' and 'current entry price'. Some of these constituents consider the term 'fair value' to imply that anything that is not labelled 'fair value' is, by default, an 'unfair value'.

15 Some respondents think the term 'fair value' should be retained because:

a they think there is no real difference between an entry price and an exit price and therefore see no reason to change the terminology;

b 'fair value' is widely used and understood; and

c IFRSs and in US GAAP need to use the same terms with the same meaning for convergence purposes. Because 'fair value' is used in SFAS 157, they think IFRSs should also use the term 'fair value'. Otherwise, they are concerned that constituents might be confused if different terms are used (eg 'fair value' in US GAAP and 'current exit price' in IFRSs) with the same meaning.

Q6	**Does the exit price measurement objective in SFAS 157 differ from fair value measurements in IFRSs as applied in practice? If so, which fair value measurements in IFRSs differ from the measurement objective in SFAS 157? In those circumstances, is the measurement objective as applied in practice an entry price? If not, what is the measurement objective applied in practice? Please provide a basis for your views.**

16 Respondents think there are circumstances in which IFRSs refer to an entry price rather than an exit price. For example, IFRS 2, IFRS 3, IAS 16 *Property, Plant and Equipment* and IAS 17 *Leases* seem to point to an entry price. They also think the use

of a principal market in SFAS 157 differs from the use of the most advantageous market in IAS 39 and the most relevant market in IAS 41.

Issue 2B. Market participant view

Q7	**Do you agree with how the market participant view is articulated in SFAS 157? Why or why not?**
Q8	**Do you agree the market participant view in SFAS 157 is consistent with the concepts of ‘knowledgeable, willing parties’ and ‘arm’s length transaction’ as defined in IFRSs? If not, how do you believe they differ?**

17 Many respondents agree that the market participant view in SFAS 157 is consistent with the concepts of ‘knowledgeable, willing parties’ and ‘arm’s length transaction’ in IFRSs. However, many find the term ‘market participants’ misleading if there is no market (ie when the market is hypothetical), in which case entities must rely on unobservable inputs. In such situations, they believe the concepts of ‘knowledgeable, willing parties’ and ‘arm’s length transaction’ are more appropriate than SFAS 157’s market participant view because they think the IFRS concept implies a hypothetical transaction whereas SFAS 157 implies an actual transaction.

18 Many respondents question how a market participant view can be relevant when there is little or no market activity for the asset or liability. They question the representational faithfulness of measurements based on ‘the entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability’ (SFAS 157.30). They think ‘hypothetical assumptions about hypothetical market participants in hypothetical markets’ do not provide useful information. They also think that they are not ‘allowed’ to use entity-specific assumptions and that they must perform an exhaustive search for the assumptions market participants would use.

19 Respondents also wonder how to identify market participants since it is unlikely that all would have a common view regarding inputs they would use in pricing an asset or liability.

Issue 2C and Issue 6. Transfer versus settlement of a liability and Valuation of liabilities

Q9	**Do you agree that the fair value of a liability should be based on the price that would be paid to transfer the liability to a market participant? Why or why not?**

20 Many respondents question the relevance of measuring liabilities at fair value. Even if liabilities are measured at fair value, they favour a settlement price over a transfer price. However, they disagree on whether a settlement price should reflect settlement in due course (ie the present value of a future settlement value) or an immediate settlement (ie a current settlement value).

21 Many think the fair value of a liability should be based on its transfer price only when:

a there is an active market on which to base the transfer price;

b the entity has the intention of transferring the liability; and

c the entity has the ability to transfer the liability.

22 They think the concept of highest and best use for an asset could be applied also to liabilities. They think business settle liabilities by extinguishing them (either in due course or immediately) or by transferring them and that criteria could be developed to assist in determining which amount to recognise.

23 Many respondents question whether an entity could use the quoted market price for traded debt securities to measure the transfer price of its own financial liabilities because presumably the market price for traded debt securities is the price at which the entity could settle its obligation by buying back the securities (ie current settlement). However, some note that the quoted market price is based on the expected settlement characteristics of the instrument, which reflects a settlement at maturity rather than a current settlement. Respondents differ in how they think SFAS 157 would apply in this case:

a some think SFAS 157 would require an entity to use this price to measure the fair value of the liability, because it is a quoted price in an active market.

b others think SFAS 157 would prohibit an entity from measuring the fair value of the liability based on the quoted market price because it is the price in an asset trading market, not a transfer market. They note that there might be a difference between an exit price to the *holder of the asset* (which might be readily observable) and a transfer price from the *issuer of the liability* (which rarely will be observable).

Q10 Does the transfer measurement objective for liabilities in SFAS 157 differ from fair value measurements required by IFRSs as applied in practice? If so, in practice which fair value measurements under IFRSs differ from the transfer measurement objective in SFAS 157 and how do they differ?

24 Many respondents think the measurement objective for liabilities in IFRSs is based on a settlement notion, not a transfer notion, particularly for non-financial liabilities and view a transfer price as a change to current practice. They think the fair value measurement in IFRSs would be based on the entity's own expected costs to settle the liability. However, respondents differ as to whether the settlement notion in IFRSs is based on a current or future settlement.

Q16 Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value of a liability? If not, why?

25 Some respondents think it is appropriate to reflect the risk of non-performance (including credit risk) in a fair value measurement because liabilities are priced on the basis of the risk that the issuing entity will not perform. However, many are concerned that reflecting non-performance risk in the fair value leads to counterintuitive results when there is a change in credit standing and the liability is remeasured at fair value. Some respondents in the insurance industry note that the proposal for Solvency II would not allow insurance companies to include the effects of 'own credit' in the valuation of insurance liabilities.

26 Many respondents are unsure what is meant by 'non-performance risk', in addition to credit risk, and ask for guidance.

Issue 3. Transaction price and fair value at initial recognition

Q11 In your view is it appropriate to use a measurement that includes inputs that are not observable in a market as fair value at initial recognition, even if this measurement differs from the transaction price? Alternatively, in your view, in

the absence of a fair value measurement based solely on observable market inputs, should the transaction price be presumed to be fair value at initial recognition, thereby potentially resulting in the deferral of day-one gains and losses? Please give reasons for your views.

27 Some respondents think the transaction price is the best evidence of fair value and assets and liabilities should not be recognised at another amount on initial recognition, unless circumstances indicate that it should be (eg it is not at arm's length, the transaction did not take place in the principal (or most advantageous) market or there is clearly a bargain purchase or overpayment). They question the appropriateness of 'earning something without doing anything' and are concerned about the reliability of fair value measurements using unobservable inputs when the measurement differs from the transaction price. These respondents think it is inappropriate to recognise day one gains and losses.

28 On the other hand, some respondents think the transaction price is *not* always the best indicator of fair value because entities transact in order to make a profit. Therefore they think day one gains and losses should be recognised even when the measurement uses unobservable inputs. They think the principle underlying a particular measurement attribute should not be compromised solely because some people do not agree with the consequences. They think it is inconsistent to prevent the recognition of day one gains or losses when the measurement is based on unobservable inputs when fair value can be estimated using those same inputs. They think that, if the Board is concerned about the recognition of day one gains or losses, it should not allow fair value to be measured on a basis that could give rise to such gains and losses. As one respondent states, 'If a fair value is a reliable measurement for the balance sheet, it should be a reliable measurement for the income statement'.

29 Furthermore, some note that deferring day one gains and losses simply defers the problem to another period, when the remeasurement is performed. If the item is remeasured at fair value using an exit price, these respondents think there is no reason not to recognise the gain or loss initially. They think it is inconsistent to allow remeasurement using unobservable inputs, but not initial measurement. Conversely, some think that if unobservable inputs are not allowed at initial recognition, they should not be allowed for subsequent measurement because it would result in a day two gain or loss.

Q12	**Do you believe that the provisions of SFAS 157, considered in conjunction with the unit of account guidance in IAS 39, would result in a portfolio-based valuation of identifiable risks of instruments considered in aggregate, or an in-exchange exit price for the individual instruments? Please give reasons for your views.**

30 Many respondents think SFAS 157 and IAS 39, together, would result in an in-exchange exit price for the individual instruments when there is an active market. However, many think that, when there is no active market, the guidance in IAS 39 and SFAS 157 supports a portfolio approach. Many respondents think the unit of account should be addressed in the fair value measurement standard to enable greater consistency in application.

Issue 4. Principal (or most advantageous) market

Q13	**Do you agree that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability? Why or why not?**

31 Many respondents agree that the principal market should be used, and in its absence the most advantageous market. Others think that rational, profit-seeking entities will always use the most advantageous market (after allowing for transaction costs). They do not agree that a fair value measurement should be based on the principal market when a more advantageous market exits.

32 However, many prefer the approach in IAS 41, which refers to ‘the most relevant’ market, for example ‘the market expected to be used’. They think the appropriate market is the one in which the entity usually transacts or expects to transact, and think it would be strange to use a different market from that in which the transaction for the asset or liability took place originally, or will take place upon eventual sale or transfer. Some think the principal market *is* the market in which the entity usually transacts.

33 Some respondents ask for clarity on what constitutes a ‘market’, for example the distinction between retail and wholesale markets and what to do when there is no market (eg in level 3).

Issue 5. Attributes specific to the asset or liability

Q14	**Do you agree that a fair value measurement should consider attributes specific to the asset or liability that market participants would consider in pricing the asset or liability? If not, why?**

34 Nearly all respondents agree that a fair value measurement should consider attributes specific to the asset or liability. As one respondent states, ‘Otherwise, a different item is being valued’. However, many are unsure how to determine which attributes a market participant would consider in pricing the item. What a market participant considers to be an attribute might not be the same as what the reporting entity considers to be an attribute.

Q15	**Do you agree that transaction costs that would be incurred in a transaction to sell an asset or transfer a liability are an attribute of the transaction and not of the asset or liability? If not, why?**

35 Many respondents agree with SFAS 157 that transaction costs incurred in a transaction to sell an asset or to transfer a liability are an attribute of the transaction and not of the asset or liability. However, many respondents understood this to mean that transaction costs always will be expensed. Rather, the Board’s preliminary view is that transaction costs are separate only from the fair value measurement and that the treatment of transaction costs will be addressed in each IFRS (in other words, it does not mean that they always will be expensed).

36 However, many ask for clarification on what constitutes a transaction cost. They think anything taken into account in the pricing process is an attribute of the asset or liability and should be included in the fair value measurement.

Issue 7. ‘In-use valuation premise’ vs ‘value in use’

Q17	**Is it clear that the ‘in-use valuation premise’ used to measure the fair value of an asset in SFAS 157 is different from ‘value in use’ in IAS 36? Why or why not?**

37 Nearly all respondents agree that the ‘in use’ valuation premise in SFAS 157 is different from ‘value in use’ in IAS 36, although many think using similar terms is confusing.

38 Many respondents used this question as an opportunity to voice concerns about the concept of highest and best use (eg the interaction between the unit of valuation and

the valuation premise, the entity's planned use of the asset and the availability of complementary assets).

39 The staff notes that many respondents use the term 'value in use' to reflect a 'fair value based on the entity's use (not sale) of the asset or liability' rather than the entity-specific notion in IAS 36.

Issue 8. Fair value hierarchy

Q18 Do you agree with the hierarchy in SFAS 157? If not, why?

Q19 Are the differences between the levels of the hierarchy clear? If not, what additional information would be helpful in clarifying the differences between the levels?

40 Most respondents agree with the hierarchy in SFAS 157 and like the fact that it prioritises the use of market inputs. However, many think there might be practical difficulties in its application.

41 Respondents request guidance on the following:

a what constitutes an 'active' market;

b distinguishing between observable and unobservable inputs in levels 2 and 3;

c applying the concept of 'using the entity's own assumptions about assumptions that market participants would use in pricing the asset or liability' in level 3;

d the interaction between the hierarchy, the principal market, and highest and best use; and

e the interaction between the hierarchy and the use of valuation techniques.

42 Some respondents think the values derived using level 3 inputs are not in fact 'fair values' and that a *fair value* measurement must be based on observable information.

Issue 9. Large positions of a single financial instrument (blocks)

Q20	**Do you agree with the provision of SFAS 157 that a blockage adjustment should be prohibited for financial instruments when there is a price for the financial instrument in an active market (Level 1)? In addition, do you agree that this provision should apply as a principle to all levels of the hierarchy? Please provide a basis for your views.**

43 Very few respondents agree with a prohibition on blockage discounts when an entity holds a large position of a financial instrument. Blockage factors represent the reduction in the price of a security that might be realised if an entity were to dispose of its entire holding at one time because of the market's inability to absorb the sale of the quantity held. Those who agree with the prohibition of blockage factors do so mainly because of the perceived subjectivity of calculating the discounts. They also think comparability will be reduced because entities will need to ask 'how many shares do I need to have before I have a block?'.

44 Those who disagree with the prohibition do so for the following reasons:

a the prohibition is a rule rather than a principle; and

b it is inconsistent with an exit price because it does not reflect the amount that would be realised by selling the holding. They think a fair value measurement excluding blockage discounts is meaningless.

45 Whether or not there is a prohibition, many think the provision should be applied at all levels of the hierarchy. They are unsure why there would be a difference between level 1 and levels 2 and 3.

Issue 10. Measuring fair value within the bid-ask spread

Q21	**Do you agree that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances, as prescribed by paragraph 31 of SFAS 157? Alternatively, do you believe that the guidance contained in IFRSs, which generally requires assets to be valued at the bid price and liabilities at the ask price, is more appropriate? Please explain the basis for your view.**

46 Many respondents think fair value should be based on the price within the bid-ask spread that is most representative of fair value. They think this is a principles-based

approach. However, some ask for guidance on how to select the place within the bid-ask spread that is most representative.

Q22	**Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed even when another price within the bid-ask spread might be more representative of fair value? Why or why not?**

47 Many disagree with allowing a pricing convention (eg mid-market pricing or bid prices for assets and ask prices for liabilities) unless the difference in fair value is immaterial. However, some think a pricing convention increases consistency and comparability amongst firms. Furthermore, some think choosing 'the most representative price' is inconsistent with an exit price notion.

Q23	**Should bid-ask pricing guidance apply to all levels of the hierarchy, including when the fair value measurement includes unobservable inputs? Why or why not?**

48 Many think the bid-ask spread guidance should be applied in all levels of the hierarchy, although some wonder how it could be applied outside level 1.

Issue 11. Disclosures

Q24	**Do the disclosure requirements of SFAS 157 provide sufficient information? If not, what additional disclosures do you believe would be helpful to users and why? Alternatively, are there disclosures required by SFAS 157 that you believe are excessive or not beneficial when considered in conjunction with other disclosures required by IFRSs? Please provide a basis for your view.**

49 Some respondents think it is too soon to address the disclosures that a fair value measurement standard might require. They think that too many items need to be addressed (including which items will be measured at the 'new' definition of fair value) for them to be able to comment at this time.

50 Many respondents caution against requiring large amounts of disclosure, particularly given the disclosures currently required by IFRS 7 *Financial Instruments: Disclosures*. They suggest that the Board select from the SFAS 157 disclosures and the IFRS disclosures to create the clearest presentation of the information.

51 Some respondents foresee a large amount of disclosures for entities in emerging markets since most of the fair values for those entities will be in levels 2 and 3.

Issue 12. Application guidance

Q25	**Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply under IFRSs? If not, please specify what additional guidance you believe is needed and why.**
Q26	**Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply in emerging or developing markets? If not, please specify what additional guidance you believe is needed and the most effective way to provide this guidance (for example, through additional implementation guidance or through focused education efforts)?**

52 Respondents differ in whether they think the amount of application guidance is too much, too little or just right. However, many respondents request further examples illustrating the measurement of non-financial assets (eg property, plant and equipment and intangible assets), financial liabilities (ie estimating the transfer price), non-financial liabilities (eg performance obligations and pension obligations) and the application of level 2 and level 3 inputs. They also ask for guidance on distinguishing between 'observable' and 'unobservable' inputs.

53 Furthermore, many respondents note the inter-relationship between some aspects of SFAS 157 (for example, the reference market, highest and best use, the hierarchy and valuation techniques) and ask for additional examples that illustrate this inter-relationship.

54 Some respondents think the examples in Appendix A are sufficient, but suggest modifying some of them to provide clarity.

55 The staff understands that fair value measurement poses particular issues for entities operating in emerging markets, although many of these issues also are relevant for entities in developed markets. Respondents note that entities operating in emerging markets have a need for education and training and have unique regulatory issues.

Issue 13. Other matters

Q27	**Please provide comments on any other matters raised by the discussion paper.**

56 Some respondents note that the discussion paper does not include the Board's views on whether the transitional provisions of SFAS 157 would be adopted or the Board's views on effective dates and early adoption (many financial institutions would like the

Board to allow early adoption). Some respondents think transitional provisions will be needed for day one gains and losses since the treatment in SFAS 157 is different from that in IAS 39.

57 Some respondents also note that the discussion paper does not include the Board's views on reliability thresholds or practicability exceptions and ask that these be included in an exposure draft of an IFRS on fair value measurement.

58 Lastly, some respondents note that the discussion paper provides the Board with an opportunity to learn from the experiences of the companies adopting SFAS 157 and can take these into account before publishing an exposure draft (and an IFRS) on fair value measurement.