



Markit Valuations
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Director, Accounting Standards
Canadian Accounting Standards Board
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19th May 2006

Dear Sir / Madam

We are responding to your request for comments on the Discussion Paper: Measurement Bases for Financial Accounting – Measurement on Initial Recognition.

BACKGROUND

By way of introduction, Markit is the leading provider of data and valuations services used by all the largest investment banks and other participants in the financial markets. One such service, Totem Valuations, was established in early 1997 to establish “fair value” market levels in over-the-counter derivatives markets. The basic principle of our service is one where multiple participants submit their best estimate of mid-market price for the assets or liabilities they hold in their trading books. We collate all contributions across multiple, related asset classes and create a single composite price. All prices are rigorously tested to ensure they are appropriate given other pricing levels and market inputs. Following continual analysis and testing over the years we can show that the resulting prices are more representative of “fair value” than those from any other source, whether closing prices in exchange traded markets, inter dealer broker prices or traded levels.

Today, all the major investment banks, broker dealers and commodities traders use Markit's services to assist them in the process of determining the fair value of their trading books. A large number of US and international banks incorporate Markit's independent price information for derivatives in equity, interest rate, currency, credit and commodity markets in the preparation of their financial accounts.

Over the past years Markit Valuations has accumulated a significant amount of knowledge and data on the derivatives markets and we feel that we are well placed to comment on the issues surrounding Fair Value Measurement. We have also previously been involved in discussions with accounting standards boards concerning the FASB's revisions to FAS 133 and EITF02-3.

Please find below a summary of our comments on the Discussion Paper and responses to the questions asked:

FAIR VALUE

We were encouraged to see that the CASB has adopted a very pragmatic approach to measurement on initial recognition. The approach reflects many of the comments and views expressed by derivatives users and market participants over the previous three years. It appears that significant efforts have been made to ensure that the accounting view does not differ significantly from the economic view.

We entirely concur that a single definition of fair value, together with a framework for measuring fair value, should result in increased consistency and comparability in financial accounts.

SUBSEQUENT REMEASUREMENT

Although the terms of reference of the discussion paper concern specifically measurement on initial recognition it is hard to disassociate this from measurement on an on-going basis.

The vast majority of our clients perform remeasurement on a daily basis. Initial recognition may occur minutes before the market close and the subsequent remeasure will take place at the close.

In the absence of specific guidance on subsequent remeasurement, there may be a temptation to ignore the initial recognition issues altogether and, for simplicity, use the transaction price as 'fair value'. Any profit or loss element will then be realised on the first remeasurement.

We would welcome a comprehensive standard that covered both initial recognition and subsequent remeasurement. For both situations we believe that marking to fair value is appropriate and that remeasurement should occur on a regular basis.

OBSERVABILITY

Both the fair value objective and level 1 of the measurement hierarchy incorporate the phrase 'observable market price'. The FASB also uses the concept of observability in both the FSP FAS 133-a and the working draft FAS 15X, Fair Value Measurements. The concept of observability and what constitutes an observable price are issues that have caused much debate amongst our client base and their auditors.

We, and I believe many of our clients, would welcome further guidance as to what constitutes an 'observable market price'.

CONCLUSION

We believe that the most appropriate method in establishing fair value combines all available information sources and weighs up the validity of each source. We recommend that the standard setters allow entities to use a single, appropriate valuation technique that incorporates all of the available evidence.

We refer the CASB to the IAS 39 paragraph 48A that states: "The best evidence of fair value is quoted prices in an active market". The definition of an active market is then further clarified in AG71 where it is stated: "A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis". We believe this evidence-based approach to fair value clearly encompasses the appropriate balance.

Finally we believe that, where available, a high quality, independent price benchmarking service, such as that provided by Markit Valuations, will add significant weight to the validity of the fair value estimates used by market participants.

We hope that the Board finds our perspective on the issues interesting and beneficial to their work. Please do not hesitate to contact us directly if you would like us to expand on any of the points raised.

Yours faithfully

Tim Barker
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Responses to questions

Question 2

We entirely concur that the objective of fair value measurement is to represent the market value of an asset or liability at the measurement date.

We would welcome further guidance of what constitutes an observable market price although we would agree that in the absence of an observable price, the fair value objective is to estimate what the market price would be if there were a market. This is consistent with the 'hypothetical transaction' concept introduced by the FASB in FAS 15X.

For clarity, we would welcome the inclusion of a statement of the 'market value measurement objective' within the definition of fair value.

Question 4

We agree that the Market Value Measurement Objective is to reflect the price that would result from an open and active competitive market process. For the last 9 years the Totem service has effectively been establishing this price by using 'best estimate of mid-market value' as the basis for our consensus prices.

The definition of market given in paragraph 55 (condensed version) would equate to a 'wholesale market'. Using the hardware retailer example in paragraph 77 (condensed version) this would represent the retailer buying the nails from his suppliers. There is a separate 'retail' market, consisting of customers who wish to purchase nails that have a choice of hardware shops but do not have direct access to the 'wholesale' market of nail suppliers and retailers.

Question 7

We would agree that there is only one market 'fair' value. However, given that there may be multiple markets there will be equilibrium prices in each market. The equilibrium price in the 'retail' market would be different from the equilibrium price in the 'wholesale' market. The difference in price is due to the 'wholesale' market being inaccessible for 'retail' customers. This is effectively a transaction cost.

Question 14

We believe that fair value should be used whenever it can be reliably measured.

As discussed previously we would like to see some further guidance on re-measurement after initial recognition.

Question 15

We welcome the premise that a single transaction price should not be accepted to be equal to fair value unless there is persuasive evidence that it is. This is the reverse of the position in EITF02-3 where transaction price was considered the most appropriate measure of fair value, although this argument has been mitigated by the introduction of the Transaction Price Presumption Rebuttal in the FASB's FSP FAS 133-a.

We have always been concerned that a reliance on transaction price might encourage the use of 'reference trades' which are open to manipulation. By removing the reliance, we hope that data from all available sources will be used when assessing the fair value of an instrument.

Question 18

As above, we would welcome further guidance as to what constitutes an 'observable market price' within Level 1. There is still much deliberation around this concept as was introduced in the FASB standards. There is a great need for the standard setters to be more explicit.