23 September 2009

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The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Sirs

FAIR VALUE MEASUREMENT

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the exposure draft, *Fair Value Measurement*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REPRESENTATION

ICAEW REP 106/09

FAIR VALUE MEASUREMENT

Memorandum of comment submitted in September 2009 by The Institute of Chartered Accountants in England and Wales, in response to the International Accounting Standards Board exposure draft, *Fair Value Measurement*, published in May 2009

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the exposure draft (ED), *Fair Value Measurement*, published by the International Accounting Standards Board (IASB).

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

MAJOR POINTS

5. The approach adopted in the ED is similar in principle to that in the discussion paper (DP), *Fair Value Measurements*. We expressed a number of fundamental concerns in relation to the DP (see ICAEW REP 38/07) and, at the level of principle, these continue to apply to the ED. We believe, though, that the valuation techniques and guidance in the ED are likely to overcome a number of these difficulties in practice. Indeed, we suspect that, if implemented, the ED might have relatively little effect on existing measurement practices.

6. If this analysis is correct, and subject to certain clarifications suggested below, then we would have no major objections to the ED's proposals on measurement, as we believe that current practices for existing IFRS measurement requirements are broadly satisfactory. There are of course important questions as to the scope of existing fair value measurement requirements, but that is a separate issue. There are also significant practical difficulties in estimating fair values in the absence of active markets, but we do not think that these difficulties would be made any worse (or better) by the proposals in the ED.

Convergence with US GAAP

7. We have indicated within this response where the IFRS approach ought to prevail over US GAAP. Obviously it would be ideal if IFRS and US GAAP both moved as necessary to reach the same high-quality solution and thus convergence was promoted. However, this should be a secondary consideration in that the IASB should aim to reach a high-quality solution for IFRS even if it has not been possible to achieve consensus with the FASB.

Exit and entry prices

8. We still consider that fair value should not always be measured as an exit price. Under current IFRS, fair value is in practice measured sometimes as an entry price, sometimes as an exit price, and sometimes as an exchange value. In different circumstances, each of these approaches is appropriate. For example, under current IFRS, fair value is often used as a substitute for cost in circumstances in which no cost measurement is available (eg, for

separable assets and liabilities in a business combination) or where historical cost is not relevant. In such cases, where a substitute is being sought for an unavailable entry price, it seems logical that the substitute value should be calculated on an entry-price basis.

9. Fair value is also used in IFRS as an updatable measure of current value in circumstances where historical cost is considered to provide significantly less useful information (eg, for certain financial instruments). In such cases, an argument can be made for either exit prices, entry prices or alternative fair value bases (eg, mid-market price), and in practice each is used in different circumstances – and appropriately so, in our view.

10. We note that a key point in the ED's argument against using entry prices is 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'. (BC28). A footnote adds that, where there is a difference between the two prices, it should be attributed to transaction costs. We agree with these statements where markets are perfectly competitive (which is usually not the case). However, given the ED's analysis, it is not clear why the preference in principle is for exit prices rather than entry prices if the two are thought to be essentially the same.

11. Indeed, given the analysis in the ED, it would be more logical to describe fair value as an 'exchange value'. This is in substance what the ED is proposing, as its argument is that in principle exit prices and entry prices are the same, if transaction costs are ignored. As the ED proposes that transaction costs should be ignored, what remains is an exchange value. Such an approach would be consistent with that adopted until recently by the IASB, which previously defined 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'. A similar exchange value definition appears in the Financial Accounting Standards Board's Statement of Financial Accounting Concepts No 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. We believe that an exchange value approach would be more appropriate, and compatible with using entry or exit prices, as appropriate, as practical ways of determining fair value.

Clarifications on the application of the definition of fair value

12. We noted above that a number of the difficulties that attach to the ED's approach in principle seem likely to be overcome in practice by its valuation techniques and guidance. However, it would clearly be unsatisfactory for these techniques and guidance to achieve results that are incompatible with the ED's principles. We therefore suggest that the explanations in the ED should be clarified so as to explain how the value in use and replacement cost approaches described there will in fact achieve exit prices compatible with its central requirement. The identity that the ED describes between entry and exit prices may make this easier.

13. In particular, in terms of overcoming the difficulties that attach to the ED's approach in principle, we note that in many cases an exit value that reflects the highest and best use of an asset that has been installed and configured could only be achieved by selling that asset as part of the operation in which it is used. This is because any other method of disposal would result in the asset no longer being installed and configured, and the exit price would correspondingly be reduced. We therefore suggest that the ED should state explicitly that an assumption of disposal as part of the sale of an associated operation is a legitimate exit price.

Fair value of liabilities

14. We recognise that, where fair value is to be measured as an exit price, there is a case for using transfer prices for measuring liabilities on the argument that the transfer of a liability is the logical equivalent of the sale of an asset. However, the ED employs the concept of 'highest and best use' for assets, being either an 'in use' or 'in exchange' (ie, transfer) value. It also states that the highest and best use concept is not relevant for liabilities. While we agree with this, the ED makes no attempt to develop an equivalent concept for liabilities. But it is arguable that for liabilities the equivalent of 'highest and best use' is what we might call 'lowest and best

relief'. This is the mode of exit from a liability that allows it to be relieved at the lowest cost to the liability holder, which is the economically rational approach – in the same way that highest and best use describes the economically rational approach for assets. The options available for exit are transfer and fulfilment (either by performance or settlement). The ED should recognise that the usual, and economically rational, mode of exit from liabilities is not transfer, but settlement or performance, and so measurement on this basis will often provide a more useful current value for a liability.

15. If the Board none the less decides to retain its definition of the fair value of a liability as a transfer price, we believe that this will further restrict the circumstances in which fair value provides the most useful measurement of a liability. We therefore suggest that, if fair value is defined in this way, there should be a review of existing fair value measurement requirements for liabilities with a view, where appropriate, to replacement of the fair value requirement by another approach to the measurement of current value. An instance where this might be desirable is the measurement of provisions for future expenditure in a business combination. In this case, we believe that the appropriate form of measurement would be the expected cash flows discounted at an interest rate that does not reflect the entity's own credit risk. (On this, and some comments on the measurement of liabilities generally, see our response to *Credit Risk in Liability Measurement*, ICAEW Rep 89/09. As noted there, we may wish to revisit this question when we have had an opportunity to consider the forthcoming discussion paper on the measurement of assets and liabilities expected as part of Phase C of the Conceptual Framework project.)

Disclosure requirements

16. The disclosures proposed in the ED could well be extensive, especially for Level 3 measurements, and we are not convinced that all of them are justified. It is difficult to judge the costs and benefits of these proposals in advance for all the varied circumstances in which they will apply. Also, it is not clear that the same disclosure requirements will be appropriate in all cases where fair value is used. We therefore believe that disclosure requirements for fair value – unlike the definition and guidance on its measurement – are something that would best be dealt with in individual standards, topic by topic.

17. If it is decided to retain the disclosure requirements proposed in the ED, we believe that some clarifications are necessary. For example, we assume that they are aimed at items remeasured at fair value at the balance sheet date rather than items initially recognised at fair value – which would potentially bring a very large number of items within their scope, eg, most items recognised in a business combination.

RESPONSES TO SPECIFIC QUESTIONS

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?

18. As noted above, we remain of the view expressed in our comments on the DP that fair value should not always be an exit price. However, subject to the clarifications requested above, we believe that the explanations and guidance in the ED are likely to lead to the proposed standard's implementation in such a way that the problems that arise in principle from the proposed definition will to a large extent be avoided in practice.

19. For example, the cost approach (in 'valuation techniques'), although intended to be a way of helping to ascertain a selling price, is likely in practice to lead to measurements that appear to be current entry prices. It needs to be clarified that they will indeed be exit prices, consistent with the ED's definition of fair value. Similarly, where an asset's highest and best use is 'in use', it needs to be clarified that an exit price derived from a hypothetical sale of the operation of which it forms a part will provide a basis for calculating a fair value that is consistent with the ED's definition (see paragraph 13 above).

20. Again as noted above, we believe that the logic of the ED leads towards an exchange value definition, and we believe that this would be preferable.

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?

21. We have no objection to the proposed changes in the three instances in which the ED identifies that existing fair value requirements will no longer be appropriate in the light of the new definition of fair value. However, we have explained (paragraph 15 above) that we do not believe that fair value defined as a transfer price will give the most useful current value for many liabilities. We therefore propose that existing requirements to measure liabilities at fair value should be reviewed to identify where alternative current value measurements would be more appropriate.

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?

22. We support this proposal for the reasons given in the IASB's *Basis for Conclusions*. We note, however, that what is 'the most advantageous market' depends on the perspective of the reporting entity and is, therefore, entity-specific. While we believe that this is the right approach, we note that it appears to be inconsistent with the ED's statement that fair value is not an entity-specific measurement.

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?

23. We believe that market participants are adequately described.

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?

24. We believe that the proposals referred to in (a) and (b) are appropriate.

25. We do not see why a different approach is appropriate for financial assets. The ED's argument (BC51) is that '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.' However, financial assets are in practice 'used' in different ways (ie, held for different purposes) according to an entity's business model. This is accepted in the IASB's exposure draft, *Financial Instruments: Classification and Measurement*, which recognises that the use of a financial instrument (and how it should be measured) depends in part on how it is managed.

26. We also question the logic of the argument in BC51. If there is a higher and better alternative use of an asset, this will be reflected in its fair value, as market participants will take the alternative use into account in deciding what they are prepared to pay for it. It is quite possible that the alternative use will involve a change in the nature of the asset, whether it is a physical asset or a financial one. For example, agricultural land might have a higher alternative use as the site for a block of flats. And, as the ED points out, a financial asset might have a higher alternative use if it is repackaged in a securitisation. In both cases, the realisation of the higher alternative use will involve a change in the nature of the asset, but it seems illogical because of this to say that the higher alternative use is irrelevant to the determination of fair value.

27. We agree that the highest and best use of a liability is not a concept that makes sense. However, as explained at paragraph 14 above, we believe that an equivalent concept should be developed for liabilities. While fair value is defined exclusively in terms of transfer, it is rational for market participants, in thinking about what price they would have to pay to transfer a liability, to consider how market participants would seek to exit the liability in due course, which would usually be by fulfilment (settlement or performance) rather than transfer. This parallels the position for assets, where it is rational for market participants in thinking about what price they would achieve in selling an asset to take into account its highest and best use (whether market participants would realise more by holding the asset for use or for resale) and what its replacement cost would be (which sets an upper limit).

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?

28. We have no objections to the proposed guidance.

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?

29. (a) We accept that transfer price for liabilities is the logical equivalent of selling price for assets. As noted above, however, we do not believe that such a notion is an appropriate current measure for most liabilities.

30. (b) In some cases, firms' liabilities are traded in the market for corporate debt. Debt markets are markets for assets that participants pay to acquire, not markets for liabilities that they pay to transfer. We find it difficult to see what adjustments would satisfactorily transform the value of the asset in such a case into a transfer value of the liability. The value of the asset will reflect, among other things, credit risk. But credit risk depends on the underlying security, which will not necessarily transfer to anyone assuming the liability.

31. (c) Although the valuation technique described (ie, present value) is intended to achieve a transfer value, we suspect that in practice it is likely to produce best estimates of settlement or fulfilment values. It will therefore be helpful to provide clarification that such values do indeed meet the proposed definition of fair value.

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?

32. (a) We agree that, as defined, the fair value of a liability includes non-performance risk. However, we question whether fair value is the most useful measurement of liabilities in all circumstances. See our comments on the *Credit Risk in Liability Measurement* discussion paper.

33. (b) In our view, the fair value of a liability **is** potentially affected by restrictions on its transfer. The purpose of restrictions on transferability is to protect the creditor. In the absence of such protection, the liability potentially has a lower value. That is why the restrictions are there.

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?

34. We agree that where an item is required to be valued at fair value at initial recognition, and this amount varies from the transaction price, any resulting gain or loss should be recognised unless the relevant IFRS for the asset or liability requires otherwise. However, for financial instruments, it would be helpful if the differences between IFRS and US GAAP could be addressed in due course, when time allows.

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?

35. We believe that the proposed guidance is appropriate and sufficient. However, it will be helpful to provide confirmation that measurements produced in accordance with the guidance will indeed meet the proposed definition of fair value.

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?

36. As discussed above (paragraphs 16-17), we believe that disclosure requirements for fair value – unlike the definition and guidance on its measurement – are something that would best be dealt with in individual standards, topic by topic. If it is decided to retain the disclosure requirements in the proposed standard, we believe that clarifications as to their scope are necessary. (For some comments on the disclosure requirements proposed for individual standards, see paragraphs 41 and 44 below.)

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?

37. We believe that the differences between the ED's proposals and SFAS 157 are generally improvements. At the level of principle, the two documents are very similar. But we believe that the ED's practical approach on a number of issues means that, on implementation, it is likely to avoid difficulties that would arise if SFAS 157 were applied to existing IFRS.

38. However, we are concerned that the specificity of unit of account for all levels in the hierarchy in IAS 39 compared to SFAS 157, which only specifies the unit of account for Level 1 of the hierarchy, may result in practical difficulties in determining appropriate fair values under this ED compared to US GAAP. We believe that unit of account for financial instruments is an issue that is too significant to be dealt with by a consequential amendment that goes beyond clarification, and that it should be discussed and dealt with separately. As noted in our response to Question 13, we believe that portfolio valuation may be appropriate in certain cases. And as mentioned above (paragraph 34), we also consider that the differences between IFRS and US GAAP on Day 1 gains or losses should be addressed in due course.

Question 13

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

Portfolio basis

39. It would be helpful to clarify that the portfolio basis of measurement is allowed where applicable. As noted above, it may be appropriate in certain cases. In addition, it may be necessary to clarify whether adjustments to derivatives, particularly credit adjustments, can be carried out on a net basis when dealing with two or more contracts with the same counterparty. So it would be helpful if the Board could clarify that an example of determining a point within the bid-ask spread in line with a market convention (as set out in paragraph 55 of the ED) would be the determination of adjustments to derivative fair values to reflect close-out costs and credit on a portfolio basis.

IAS 19, *Employee Benefits*

40. It would be helpful to clarify that plan assets would still be required to be measured at fair value even when, under the corridor approach permitted by IAS 19, some of the actuarial gains and losses are deferred or when the ceiling test in the standard restricts the recognition of part of a surplus.

41. The disclosure requirements that would be inserted in IAS 19 by the proposals at paragraph D19 of the ED are in our view unduly extensive, particularly in relation to Levels 2 and 3. This illustrates why we consider that it would be better to deal with disclosure requirements standard by standard. It is possible that the proposed disclosures could be reduced in practice on the grounds of immateriality. It would be helpful, though, to clarify that this would be appropriate, as many disclosures that are arguably immaterial are made in order to meet various IFRS requirements.

IAS 26, *Accounting and Reporting by Retirement Benefit Plans*

42. We suggest that the proposed amendment to paragraph 33 of IAS 26 (paragraph D20 of the ED) should state that, as a practical expedient, for securities with a fixed redemption value the redemption-based amount should be deemed to be fair value.

43. It is not clear why there would continue to be a reference to 'market value' in paragraph 33 (penultimate sentence). How would this differ from fair value?

IAS 34, *Interim Financial Reporting*

44. The disclosure requirements that would be inserted in IAS 34 by the proposals at D22 of the ED are also unduly extensive in our view, particularly (in the light of our comment at paragraph 41 above) in relation to pension plan assets. It needs to be borne in mind that, while there is a general requirement in IAS 34 to ensure that information in interim reports is reliable, it is accepted in the standard that interim reports may involve a greater use of estimation methods than annual reports (see, for example, IAS 34.C4).

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