CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

28 September 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft on *Fair Value Measurement*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft. Our responses to the questions raised in your Exposure Draft are set out in the Appendix for your consideration.

We are supportive of the proposed fair value measurement framework described in the Exposure Draft in relation to the following aspects:

1. establishing a single source of guidance for all fair value measurements required or permitted by IFRSs to reduce complexity and therefore improving consistency in their application;

2. clarifying the definition of fair value and providing related guidance which will communicate the measurement objective more clearly; and

3. enhancing disclosures about fair value to enable users of financial statements to assess the extent to which fair value is used and to inform them about the inputs used to derive those fair values.

Moreover, we support the efforts to achieve convergence with the FASB as the need for the development of a consistent global approach to fair value measurement has become more apparent throughout the recent financial crisis.

Generally, we agree with the Exposure Draft's definition of 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). In the absence of an actual transaction at the measurement date, fair value measurement should assume a hypothetical transaction in the most advantageous market for the asset or liability. In addition, we believe that, at initial recognition, if the transaction price differs from its fair value, such difference should be recognised in the profit or loss unless an IFRS requires some other treatment.

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However, we are concerned about taking into account non-performance risk in measuring all liabilities. Our views on this are expressed in our comment letter to IASB's recent discussion paper on *Credit Risk in Liability Measurement* and we have restated our view in Question 8.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong

Steve Ong, FCA, FCPA
Director, Standard Setting Department

Hong Kong Institute of CPAs

Definition of fair value and related guidance

<u>Question 1</u>

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?

We consider that the definition of 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" is appropriate.

Scope

<u>Question 2</u>

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?

We agree that the existing measurements for share-based payment, reacquired rights in business combination and the fair value of a financial liability with a demand feature are inconsistent with the fair value definition in the Exposure Draft and we consider that the proposed approach to these three issues are appropriate.

The transaction

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?

We support the proposal that a fair value measurement should be based on the most advantageous market in which the entity would normally enter into a transaction for the asset or liability. We also agree that in the absence of evidence to the contrary, the principal market should be assumed to be the most advantageous market.

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?

We consider that the description of market participants in the exposure draft is appropriate. However, if the reporting entity itself is one of the market participants, we have seen confusion in understanding what are entity specific and what are market participant assumptions to be considered in pricing. In this case, we suggest clarification be made in the standard that the entity-specific factors should be excluded in the measurement.

Application to assets: highest and best use and valuation premise

<u>Question 5</u>

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?

We generally agree with the above proposals. However, we understand that the "highest and best use" valuation method is used to measure financial instruments in portfolios of assets and liabilities or both (when subject to netting arrangements) so as to overcome the unit-of-account guidance in US GAAP that would otherwise require each instrument to be measured independently. We believe that the appropriate place to deal with such unit-of-account issue is in the relevant standard. Accordingly, we recommend that the Board should consider the appropriate unit-of-account for financial instruments as part of its IAS 39 replacement project.

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?

We generally agree that the disclosures of two bases, i.e. the existing use and the alternative highest and best use, would provide useful information for users of financial statements. However, we consider that the requirement in paragraph 17 for the identified “highest and best” use to be “legally permissible” at the measurement date is inconsistent with the requirement in paragraph 18 to identify the highest and best use from the perspective of market participants and could cause confusion and diversity in practice.

For example, it is not uncommon for market values for properties to factor in higher and better uses than their current use, even if the specific planning permission has not yet been obtained for changing the use of that property. Obviously, that market value would factor in any uncertainty over the likelihood of obtaining the necessary permissions (and any additional costs involved) but if, for example, it was highly likely that the necessary permissions would be granted, then the market value of the property would be little different from what it would be if that permission had already been granted.

However, a strict application of paragraph 17 would appear to mean that in the fact pattern set out in IE5 (i.e. redevelopment of an old factory site into residential property) the buyer would need to record a day one loss if planning permission for that particular site had not been obtained prior to the transaction, since, in accordance with paragraph 17, it would seem the buyer would have to value the site as a factory site without any development potential until the actual legal permission for the plans were obtained. In our view, paragraph 17 should be amended to make clear that “legally permissible” is intended to include uses of the property which, at the measurement date, are expected to be permitted in accordance with zoning regulations, public policy, past practice in respect of similar properties in that location etc.

Application to liabilities: general principles

<u>Question 7</u>

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?

We support the proposals that the fair value of a financial liability should be based on its transfer value; the fair value of a liability will be equal to the fair value of that corresponding asset when the liability has a corresponding asset; and the present value techniques and similar techniques should be used to estimate the fair value for which there is no corresponding asset.

Application to liabilities: non-performance risk and restrictions

<u>Question 8</u>

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?

In our view, non-performance risk, including credit risk, should be considered in measuring the fair value of any liability. However, as explained in our comment letter to IASB's recent discussion paper on *Credit Risk in Liability Measurement,* we do not believe that fair value is the appropriate measurement basis for many liabilities. Accordingly, we believe that an entity's own credit risk should only sometimes be incorporated in the measurement of liabilities. In respect of initial measurement, we would only support including own credit risk when there is an actual transaction occurring and there is an associated transaction price.

In respect of subsequent measurement, we would only support including credit risk for those liabilities which are held for trading (including derivatives) and for liabilities that are quoted in an active market such that the entity has the practical ability to realize recognized gains.

Moreover, we consider that a restriction on an entity's ability to transfer a liability does not affect the fair value of the liability. The fair value of a liability, unlike an asset, is not a function of marketability, but of performance. A market participant transferee will be required to fulfil the obligation and would take that into account when determining the price it would demand to assume the liability from the entity. In other words, the market participant transferee, like the reporting entity, must perform to be relieved of the obligation.

Fair value at initial recognition

<u>Question 9</u>

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?

This proposal is not appropriate. We believe an entity should, at initial recognition, recognize the difference between the transaction price and the fair value as a gain or loss (Day 1 gain or loss) when fair value is the appropriate measurement basis for the asset or liability, irrespective of whether that fair value is evidenced by observable market prices or when using a valuation technique.

We are of the view that if the fair value measurement principles in the Exposure Draft are appropriately applied, the Day 1 gain or loss is genuine and meaningful. This would provide useful and relevant information to the users of the financial statements to assess the performance of the entity and for their better understanding of the economics of the transactions as compared to the transaction price. In this connection, we consider that the recognition and disclosure of Day 1 gain or loss should not be restricted. In addition, the estimation uncertainties in arriving at the fair values are disclosed in the financial statements

Valuation techniques

<u>Question 10</u>

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?

We believe that the proposed guidance is appropriate and sufficient

Disclosures

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?

We generally support the proposed disclosure requirements.

Convergence with US GAAP

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?

As mentioned in our cover letter, we support the IASB's efforts to achieve convergence with the FASB. Consequently, we believe that differences should only exist if they result in significant improvements. Accordingly, as noted in our response to Question 9, we do not agree with the creation of a GAAP difference regarding the IASB's proposal not to allow recognition of day 1 gains or losses.

Other comments

Question 13

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

We do not have any further comments.