Asian-Oceanian Standard-Setters Group (AOSSG) Discussion Paper

Fair Value Measurement

Asian-Oceanian Standard-Setters Group (AOSSG)
4 – 5 November 2009

DISCLAIMER

This paper prepared by the staffs from Fair Value Measurement Working Group members. With respect to contents in this paper other than Appendix I and Appendix IV, neither the AOSSG nor any member of AOSSG is expected to express any official view. Appendix I as well as Appendix IV is to be reviewed and approved by AOSSG members at the meeting on 5 November and then submitted to the International Accounting Standards Board (IASB) according to the due process described in the constitutional *Memorandum of Understanding on Asian-Oceanian Standard-Setters Group.*

WORKING GROUP ON FAIR VALUE MEASUREMENT

The Working Group on Fair Value Measurement of the AOSSG consists of the staffs from the following organizations.

LEAD

China Accounting Standards Committee (CASC)

MEMBERS

Accounting Standards Board of Japan (ASBJ)
Korea Accounting Standards Board (KASB)
Hong Kong Institute of Certified Public Accountants, Hong Kong SAR (HKICPA)
Malaysian Accounting Standards Board (MASB)

The purpose of this paper is to summarize the study carried out by the working group on fair value measurement (WG), help AOSSG members to evaluate the ongoing International Accounting Standards Board (IASB) deliberations on the project of Fair Value Measurement (FVM), and, based on discussion and efforts by AOSSG members, make a constructive contribution to the IASB's upcoming FVM standard.

Introduction

The IASB FVM Project

1. Fair value measurement is one of the most important projects in the technical agenda of the International Accounting Standards Board (IASB). In September 2005, the IASB added a project in its active agenda to clarify the meaning of fair value and provide guidance for its application in IFRSs. In November 2006, the IASB published a discussion paper *Fair Value Measurement*, using Statement of Financial Accounting Standards No.157 (SFAS 157) *Fair Value Measurement* as a basis for forming its preliminary views. In October 2008, a IASB's expert advisory panel on FVM issued a report *Measuring and disclosing the fair value of financial instruments in markets that no longer active*. In May 2009, the IASB published the exposure draft Fair Value Measurement (the ED) with a comment period ended on 28 September 2009.

2. After reviewing the comment letters received on the exposure draft and holding 3 round-table meetings in November and December 2009, the IASB will begin its redeliberations in January 2010 and finalize the standard in the second quarter of 2010.

The FVM Project of AOSSG WGs

3. Four technical issues were identified at the preparatory meeting of Asian-Oceanian Accounting Standard-setters Group (AOSSG) in Beijing on 17 April 2009. An AOSSG WG on FVM was organized by the interim secretariat at the Malaysian Accounting Standards Board (MASB) in June. The WG consisted of the staffs from China Accounting Standards Committee (CASC), Accounting Standards Board of Japan (ASBJ), Korea Accounting Standards Board (KASB), Hong Kong Institute of Certified Public Accountants, Hong Kong SAR (HKICPA), and MASB. In early September, the CASC distributed discussion points derived from the IASB ED in May to WG members. Considering the comments from WG members, the staffs prepared a draft proposal for AOSSG members' deliberations at and after the AOSSG meeting on 5 November.

4. As set forth in the *Guidelines on the Modus Operandi of an AOSSG Working Group (WG),* the objective of the WG project on FVM is to facilitate AOSSG in providing input and feedback, in the public interest of AOSSG members, to the IASB on proposed FVM standard.

Components of this Paper

5. This paper consists of following components,

a) **Body of the paper –** the body summarizes the WG project and analyzes views from WG members as well as other AOSSG members where necessary.

b) **Appendix I –** the draft proposal to be issued by AOSSG expected to be discussed and approved at the AOSSG meeting on 5 November. The Inputs

c) **Appendix II** - WG Members' responses to CASC's Discussion Points on FVM in September.

d) **Appendix III** - Summary of Comments on the IASB ED from WG Members and other AOSSG members. The Comments on the IASB ED are from the website of IASB.

e) **Appendix IV** - Challenges the Emerging Market Economies May Encounter in the Application of Fair Value Measurement According to the Exposure Draft summarized by CASC staff. All AOSSG members are invited to provide comments on it. The CASC staff proposed submitting the appendix to the IASB for the redeliberations on Emerging Market and Transitional Economies (ETEs) FVM Guidance as a input from the AOSSG.

Questions in the ED

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?

6. Most WG members supported the definition proposed by the ED, while one of them concerned application consistency of the definition, particularly where level 3 inputs are used in FVM and entity specific value may be revealed in

7. One WG member noted that, in the case of applying the level 3 inputs of valuation techniques, inputs derived from a period is inconsistent with provisions of measurement date in the definition. The WG member proposed that the IASB should clarify Board's rationale on it.

8. One of other AOSSG members proposed a clarification incorporated into the FVM Standard to regard the cost approach as consistent with an exit price notion of fair value. The member noted that using current entry values can not be avoided for many non-financial assets.

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?

9. Some WG members and other AOSSG members agreed with the proposal (a) while were opposed to the to the proposal (b). Some of them noted that the term of fair value in paragraph 49 of IAS 39 is inconsistent with defining fair value as an exit price and, therefore, another measurement term (such as 'callable amount') should be used in that context. However, these members did not comment on whether the measurement requirements for financial liabilities with a demand feature should remain in IAS 39 or be included in the Fair Value Measurement Standard. One of them did not agree with the proposal to exclude from the scope of the final standard on fair value measurement the measurement of a financial liability with a demand feature.

10. One WG member agreed with both of the proposals for the three scenarios in the ED. One of other AOSSG members raised another three scenarios for deliberations on whether the term of fair value in certain IFRSs reflected the IASB's intended FVM approach.

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?

11. Many WG members and other AOSSG members were opposed to the use of most advantageous market. Some of them concerned that the notion of advantageous from the perspective of reporting entity might overestimate fair values of assets to be measured. Some of them urged the IASB to clarify the criteria distinguishing the most advantageous market various markets and the

12. One WG member and one of other AOSSG members welcomed the proposal and encouraged the IASB to convince the Financial Accounting Standards Board (FASB) of this approach.

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?

13. Most of WG members and other AOSSG members agreed with the proposal in principle and propose different further clarifications. Some of them concerned that the sentence "and are presumed to be as knowledgeable as the reporting entity" in paragraph 13(b) was confusing. One of them argued that market participants engaged in a transaction accepting the information asymmetry and the sentence quoted above is unpractical and unnecessary, while another one of them believed that the sentence assumed that market participants would have access to “insider” information even though that information is not available in the market.

14. Some members concerned that the reporting entity itself was one of the market participants according to the ED. They argued that people may be confused by entity specific and market participant assumptions to be considered in pricing. Some of them proposed a clarification as in paragraph 26 of *Statements of Financial Accounting Concepts No.7 (SFAC 7)* to improve the principle of

15. A WG member concerned the potential restrictions to government-controlled entities in identification of market participants in paragraph 13(a).

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?

16. Most of WG members and other AOSSG members appeared to support proposal (a) and (b). One WG member had significant concerns in applying the highest and best use notion in the fair value of certain non-financial assets. It argued that the nature of the non-financial asset should be given due consideration in applying the notion of highest and best use and urged the IASB to reconsider the applicability of highest and best use notion to all non-financial assets.

17. Some WG members recommended the IASB should consider the appropriate unit-of-account for financial instruments as part of its IAS 39 replacement project or add the principles of valuation unit identification when the "in use" premise is applicable to increase the relevance between fair value measurement and specific assets groups.

18. One of other AOSSG members recommended that the IASB clarifies whether estimated cash flows should reflect entity-specific efficiencies or inefficiencies in estimating the fair value of performance obligations at level 3 of the fair value hierarchy and suggested that the IASB should explain more fully why the highest and best use notion is not relevant for liabilities.

19. One of other AOSSG members argued that the fair value of a portfolio of financial instruments should include premiums that the market is willing to pay because this is consistent with the concept of highest and best use for assets.

20. One of other AOSSG members suggested the IASB replacing the term of in use and in exchange with references to measuring an asset either as part of a group of assets or on a standalone basis, respectively.

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 recognize 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?

21. Most of WG members and other AOSSG members were opposed to the proposal. Some of them noted that it may be hard for the reporting entity to change the current way in which measured asset is used to the highest and best use for some reason such as lacking adequate experienced management team, without proper business model. Others did not believe the proposed disclosure could provide more decision-useful information while more efforts made and costs occurred to

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?

22. Some WG members and other AOSSG members generally supported the proposals on FVM of liabilities. Some of them concerned whether the proposals are practical in emerging markets.

23. Some of other AOSSG members disagreed with the proposals. They argued that fair value is not the appropriate measure for liabilities in many circumstances. For example, for many nonfinancial liabilities, the cost to fulfil the liability by performing the performance obligations itself will be less than the cost to transfer the performance obligations to another party (because a risk premium may be incurred if transferred).

24. Some members asked whether the entity's obligation is being measured or whether the obligation itself is being measured independent of the entity and entity-specific factors. They recommended that the IASB clarifies whether estimated cash flows should reflect entity-specific factors in estimating the fair value of performance obligations.

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 fulfill 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?

25. A number of WG members and other AOSSG members generally supported proposal (a) and (b), some of them argued that the point was whether FVM should be applied to many liabilities. One of them proposed an integrated consideration of how to measure the fair value and when to use the fair value.

26. Some members proposed the IASB further explain the reason why it considered the transfer restrictions in fair value measurement for assets but not for liabilities in BC75 of the ED. One of them noted that the characteristics of the participants in the relevant market for the liability would reflect restrictions on who may participate in that market.

27. Some members indicated that the IASB should fully consider the outcome of Discussion Paper *Credit Risk in Liability Measurement* before making any decision on proposal (a).

28. A WG member disagreed with the proposals to include the entity's own credit

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?

29. A number of WG members and other AOSSG members argued that the difference between the transaction price and the fair value should be recognized as a gain or loss (Day 1 gain or loss) and disagreed with the proposal to defer the recognition of any gain or loss that results from initially measuring the fair value of a financial asset or financial liability, regardless they consented to or opposed the proposal. Some of them suggested recognizing day 1 gain or loss irrespective of whether that fair value is evidenced by observable market prices or when using level 3 inputs. Others insisted on the evidence requirement.

30. A WG member expected convergence between IFRSs and US GAAP to be achieved on this issue through full deliberation in future.

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?

31. Most of WG members and other AOSSG members generally supported the proposed guidance. A WG members proposed the IASB provide more guidance, particularly on how to use level 3 inputs in FVM. One of other AOSSG members recommended that the IASB clarify whether or not depreciated replacement cost would be considered a surrogate for fair value in certain circumstances and what these circumstances would be.

32. Some members concerned ambiguity of the terminology and valuation methodology in the ED. They also recommended a note to clarify the requirements in the ED is on purpose of financial reporting rather than professional valuation. Some members encouraged the IASB to liaise with the International Valuation Standards Board (IVSB) to identify whether any clarifications or amendments to terminology are warranted.

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?

33. Some WG members and other AOSSG members concerned the some disclosure might be excessive, such as paragraph 57(e). Some members noted the reconciliation requirement might be unpractical. Two members viewed that the proposed amendment to IAS 34 in paragraph D22 was inconsistent with the underlying disclosure principle of IAS 34 (significant changes).

34. A WG member proposed the IASB add another two disclosure requirements,

- The description of the market status for users' better understanding of the information provided through fair value measurement.

- A disclosure and note of limitations on fair value measurement.

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?

(a) Scope;

(b) Reference market;

(c) Highest and best use;

(d) Blockage factors;

(e) Day 1 gains or losses;

(f) Valuation premise and financial instruments;

(g) Measurement of liabilities;

(h) Measurement of equity instruments;

(i) Wording changes.

35. Most of WG members and other AOSSG members generally supported the proposed approach except some specific issues mentioned above. Members encouraged the IASB and the FASB to work together to achieve fully converged standards, ideally by amending SFAS 157.

Other comments

Question 13

Do you have any other comments?

Guidance for Emerging Market Economies

36. Some WG members and other AOSSG members suggested the IASB providing additional guidance for emerging market economies. Appendix IV summarizes and analyzes some special problems the emerging market economies may encounter in the application of FVM. All AOSSG members are invited to comment on scenarios and examples in Appendix IV. More examples from each emerging AOSSG member are welcome. Appendix IV is supposed to be submitted to the IASB with the AOSSG proposal on FVM.

Use of Expert Panel Guidance and Further Guidance on FVM

37. Members proposed further guidance on FVM and recommended that the IASB take fully account of the best use of the educational guidance issued by Expert Advisory Panel in October 2008, which was made by the technical experts specialized in valuing financial instruments and could be more useful and helpful in practice.