ED181 sub 12

Collection House Limited

17 September 2009

The Chairman
The International Accounting Standards Board

Via website: www.iasb.org

Dear Sir / Madam

ED/2009/5 – FAIR VALUE MEASUREMENT

Please find our comments on the proposed Exposure Draft in relation to the definition of Fair Value in the International Accounting Standards.

Please feel free to contact the company if clarification is required of any of the issues raised.

Yours sincerely
COLLECTION HOUSE LIMITED

ADRIAN RALSTON
CHIEF FINANCIAL OFFICER

CC: The Chairman, Australian Accounting Standards Board

Definition of fair value and related guidance

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?

The definition is only appropriate where there is an exit price available. In situations where there is no exit price because of legal restrictions on selling assets, this definition cannot apply, yet the entity is still going to need to determine a fair value of the assets in question.

Further into the standard, it is suggested that in the absence of an actual transaction, an entity would use a hypothetical transaction, however in the situation where there is no exit transaction or possibility of one, the only way to derive a hypothetical transaction would be change the nature of the asset itself and assume that there is no restrictions on the sale, and therefore there would be an exit price.

A better definition would contemplate the possibility of there being no exit price and allow for an estimate of fair value based upon a DCF calculation.

Scope

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?

No comment.

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?

The assumption about the most advantageous market is a reasonable assumption to make under most circumstances. In situations where there are restrictions on the disposal of the assets such that the assets cannot be sold, there is no "most advantageous market" in which the transactions can take place. This situation falls outside the considerations of this paragraph.

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?

The definition of "market participants" is adequate.

Additional comment:

In a small market such as Australia where there are only a few market participants, and where pricing of assets is critical to the profitability of the entity because the asset (including financial assets) are an input to the entity's main revenue producing activity, such assumptions may be considered to be commercially sensitive, and not be available in the market place.

Perfect knowledge may assist lesser players and in the case of unlisted companies confer an unfair advantage.

Application to assets: highest and best use and valuation premise

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?

The highest and best use concept is appropriate and the consequent valuation premise is also appropriate.

The proposal in paragraph 24 of the proposed IFRS that these notions not be used for financial assets is not appropriate. In a situation in which a financial asset is used to derive the primary income stream of an entity, and is used in combination with other assets and liabilities as a group, it should be possible to apply an "in-use" valuation technique.

This is the situation for a debt collection / receivables management company which purchases debts to collect in its own name. Debts are purchased as the main input to the revenue generating process, and revenue is generated by collecting the debts using all of the other assets and liabilities of the entity. The purchased debts are financial instruments under current accounting standards. This is a situation in which an in-use valuation premise is the most appropriate premise for a financial instrument.

An "in-exchange" valuation, which under the definition provided is a stand-alone valuation, would result in the valuation being the amount that the entity believes is recoverable from the debtor. Because the debt is already past due, the "standalone" value may well be Nil. The only way value can be recovered and a profit be made is if the debt is intensively worked in combination with other assets and liabilities of the debt collection business.

The statement in paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis of Conclusion does not consider this possibility, as the assets in this situation are not held as part of a diversified portfolio. They are specifically operating assets which should be considered in-use and in combination with the other assets and liabilities of the entity.

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?

This is appropriate, as it allows the users to be aware of the true value of the assets and the choices (and inefficiencies) that the entity is making in using an asset for less than its best possible use.

Application to liabilities: general principles

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?

No comment

Application to liabilities: non-performance risk and restrictions

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?

No comment

Fair value at initial recognition

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?

Yes

Valuation techniques

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?

No, the guidance is not appropriate. Whilst it addresses the circumstances of markets that are no longer active, there is no acknowledgement of or specific guidance in relation to where there is no market at all, because of the asset restriction issue.

- *The market approach cannot apply as there is no market in which to observe transactions,*
- *The income approach is the most appropriate valuation technique as it is based upon future cashflows which an entity should be reasonably able to predict*
- *As noted in paragraph 38(c), the cost approach is most appropriate for tangible assets rather than intangible assets.*

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?

Yes, as long as the disclosures are at a high enough level to avoid forcing entities to disclose commercially sensitive information in thin markets such as Australia. In the Australian receivables management space there are 2 listed and 2 reasonably sized unlisted market participants. Overt disclosure is going to produce an uneven playing field if significant private entities are not mandated by government regulation to make the same disclosures.

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?

The specific exclusion on the in-use premise for financial instruments only considers financial instruments as part of a diversified portfolio. If an entity holds financial instruments as part of its main revenue generating activity and depends upon the combination of the financial instruments and other assets and liabilities to generate profit, it is inappropriate and unfair to force the company to use a valuation premise which may result in a fair value that is artificially low.

Other comments

Question 13

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

The underlying basis of this proposed standard is that the fair value should be a market-based approach. This does not consider the situation in which an asset or liability cannot be exchanged in an orderly market transaction because there is no market. Once the asset has been acquired from the vendor, there is no way in which to dispose of the asset other than via a repurchase by the vendor, or with the permission of the vendor. In the Australian context there is no secondary market for these assets as there is the US.

The impact of such restrictions is that there is no market, real or hypothetical, active or inactive, from which a fair value can be derived. Because there is no market, there can be no concept of "exit price" to form the basis of fair value estimation.

The proposed standard (paragraph 5) mandates that the characteristics of the asset or liability which would be considered by market participants should form part of the fair value determination. In a thin market with restrictions in place, this kind of information will be difficult to determine, and may be considered by market participants to be commercially sensitive, and therefore unable to be determined.

Similarly, there is no "most advantageous market" referred to in paragraph 8.

The "no-market" situation can, with some effort, be forced into the model set out in the proposed IFRS, however it would be clearer and easier to understand is there was a specific acknowledgment if the issue and guidance provided.

The proposed standard is confusing in that the core principle is focussed on a market environment with all of the issues outlined above, but at the same time, it tries to address the issues of there not being a clear market indication of an exit price in paragraph 38(b) and 38(c). Even then, the standard is contemplating the situation of an inactive market, and there is no acknowledgment of the situation of no market and hence no exit price.

Collection House Limited - Overview

Collection House is a public company which listed on the Australian Securities Exchange on 4 October 2000. The Collection House group of companies employs over 580 trained personnel in 12 Australasian sites.

The group focuses on providing receivables management, debt purchasing and debt collection services in all Australian states and territories and throughout New Zealand.

Further information about the company can be found at www.collectionhouse.com.au