AUSTRALASIAN
COUNCIL OF
AUDITORS-GENERAL

28 September 2009

Mr. Kevin Stevenson
Chairman
Australian Accounting Standards Board
P O Box 204
Collins Street West
MELBOURNE VIC 8007

Dear Mr Stevenson

EXPOSURE DRAFT 2009/5 FAIR VALUE MEASUREMENT

Attached for your information is a copy of the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above.

The views expressed in this submission represent those of all Australian members of ACAG.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

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ACAG AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

28 September 2009

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David

EXPOSURE DRAFT 2009/5 FAIR VALUE MEASUREMENT

Attached is the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above.

The views expressed in this submission represent those of all Australian members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill

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Chairman
ACAG Financial Reporting and Auditing Committee

CC: The Chairman - Australian Accounting Standards Board

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EXPOSURE DRAFT 2009/5 FAIR VALUE MEASUREMENT

ACAG has reviewed the exposure draft on fair value measurement and provides the following comments.

OVERALL COMMENT

ACAG welcomes the proposals that would replace fair value measurement guidance contained in individual IFRSs with a single, unified definition of fair value, as well as further authoritative guidance on the application of fair value measurement in active markets, particularly in the current economic climate.

A precise definition of fair value and a single source of measurement guidance should provide preparers and auditors with a clearer measurement objective, which will improve consistency and comparability, and provide users with a better understanding of what a fair value measurement represents.

ACAG acknowledges that accounting standards issued by the IASB are developed with a 'for-profit' focus as the Board does not have a mandate to consider public sector issues. However, as many of our clients are in the public sector and not-for-profit sectors, some of our responses may cover the impact on these types of entities.

ACAG does have some concerns with the proposals contained in the exposure draft, which are expressed in the detailed comments below.

SPECIFIC COMMENTS

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?

ACAG views 'fair value' in existing IFRSs as an umbrella term that includes exit and entry prices, which is considered appropriate depending on the type of asset or liability being subject to fair value measurement.

ACAG would prefer the definition to refer to a price to 'exchange' an asset (rather than to 'sell' an asset). There are many situations in both the public and private sectors that give rise to assets that are specialised in nature which will not have a specific selling price.

Therefore, ACAG recommends that the proposed definition be amended as follows:

> *'Fair value is the price at which an asset would be exchanged or a liability settled in an orderly transaction between market participants at the measurement date'.*

The proposed fair value model needs to clarify whether the use of 'depreciated replacement cost' in IAS 116 *Property, Plant and Equipment* will still be considered to be an appropriate proxy for fair value. ACAG note that the exposure draft makes reference to 'current replacement cost', but it is unclear whether this term is deemed to be equivalent to 'depreciated replacement cost' as neither term is defined. ACAG recommends that the IASB considers clarifying paragraph 38(c) to avoid confusion and potential for divergence in practice. In addition, it would be useful to have further guidance on measuring current replacement cost and how this measurement basis impacts the determination of fair value for heritage and cultural assets.

In relation to the liability aspect of the definition, ACAG notes that the 'transfer of liability' element of the proposed definition may not be appropriate in certain circumstances. ACAG therefore requests that the IASB and FASB consider amending this element of the definition to ensure it appropriately reflects the measurement attributes of a liability from a practical, rather than theoretical, approach. A better element of the definition would be 'the amount for which the liability would be settled'.

However, ACAG does support the notion of an 'orderly transaction' whereby such transactions require market participants that are willing and able to transact, and the asset or liability that forms part of the transaction has had adequate exposure to the market before the measurement date.

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?

ACAG agrees with the proposed approach to replace the term 'fair value' in other IFRSs where its intended meaning is not fair value.

In regards to the IAS 39 *Financial Instruments: Recognition and Measurement* requirement to measure a financial liability with a demand feature at not less than the amount payable on demand, ACAG assumes that the IASB is satisfied that the solution will remain practical in light of the project to replace IAS 39. If multiple amendments of this nature are required, ACAG would recommend that the IASB reconsider the mechanism for alternative requirements relating to fair value.

ACAG is not aware of any other issues that would require a similar approach.

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?

ACAG is of the view that the approach proposed is appropriate because the assessment is made from the perspective of the reporting entity, and is presumed to be in the market that the entity would normally enter into such a transaction.

ACAG agrees with the notion that unless there is evidence to the contrary, the principal market (the market with the greatest volume and level of activity for the asset or liability) may be assumed to be the most advantageous market if this is accessible by the entity. However, ACAG believes that the 'most advantageous market to which the entity has access' requires clarification to ensure it refers to the hypothetical seller.

ACAG supports the notion that the entity will not be required to incur additional cost or effort in locating 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?

ACAG believes that the description of market participants in the exposure draft and the use of assumptions that market participants would use in measuring the fair value of an asset or liability is appropriate.

Application to assets: highest and best use and valuation premise

Question 5
The exposure draft proposes that:

(c) 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).

(d) 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).

(e) 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?

In working out what is the highest and best use, the assumption that other market participants are all as knowledgeable as the reporting entity becomes paramount. The entity may, for example, use the asset in combination with various other assets in a complex production process. For the purpose of fair value measurement, ACAG supports the proposal to assume that other market participants will know about the complex production process and will understand that the asset is worth more as an integral part of this production process than, for example, as scrap materials.

However, the highest and best use for market participants is not necessarily that in which the asset is currently engaged or that for which it is intended. Paragraph 17(b) explains that fair value measurement must take into account only the uses which are legally permissible. In the context of the public sector, there can be restrictions on the use and disposal of assets. Some of these may be considered to be legal restrictions, but other restrictions may be less clear. Many public sector assets are held as community, cultural or heritage assets and many entities are mandated by government/ministerial directives or legal/administrative requirements to continue to provide the services that the assets assist them in providing. That is, it may not be feasible that the asset is available for its highest and best use in the near future.

ACAG supports the proposal that the highest and best use of an asset establishes the valuation premise, which may be either 'in use' or 'in exchange'. Moreover, ACAG agrees that the notions of highest and best use and the valuation premise should not be used for financial assets and are not relevant to liabilities.

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 (i.e., 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?

If fair value is determined based on the 'highest and best use' of the asset, ACAG believes that it would be inappropriate to then split the value into separate components, as proposed in the exposure draft. This would give rise to potential confusion to users of the financial statements, particularly when the amounts for numerous assets are aggregated. The proposal would require valuations to be undertaken on two bases (i.e., existing use and alternative use) which would become a significantly onerous and costly exercise for the reporting entity. It may also result in significant increases in compliance costs for preparers of financial statements, whilst not adding any value for users of the financial statements.

Notwithstanding our concerns discussed above, ACAG questions why the requirement to split the value into separate components only applies to assets used together with other assets. Within the public sector, there would be many examples where assets used in isolation are not used at their highest and best use.

ACAG suggests that more guidance be included to determine whether an 'entity uses an asset together with other assets in a way that differs from the highest and best 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?

As previously mentioned, ACAG believes that the 'settlement' of a liability would be a more appropriate and encompassing term to use in the proposed definition, compared to the 'transfer' of a liability.

The fair value of a corresponding asset does not necessarily reflect the fair value of a liability. ACAG therefore suggests that where there is no observable market price for a liability, an entity estimates the price that market participants would demand to assume the liability using present value techniques.

Notwithstanding our concerns on the use of the concept of 'transferring' a liability, ACAG supports the proposal that a fair value measurement assumes that the liability is transferred to a market participant at the measurement date.

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, i.e., 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?

When valuing a liability, ACAG does not agree with the proposals that non-performance risk should be taken into consideration. Therefore, where market participants would discount the value of a business's liabilities due to a risk that they will not repay them, ACAG does not agree that the entity should reflect this discount in arriving at the fair value of its liabilities. ACAG recommends that entities provide disclosures in regard to non-performance risk rather than including the discount in the value of the liability.

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?

From a conceptual point of view, for assets / liabilities carried at an exit price, it could be likely that the initial amount recognised may be different from the transaction price, thus resulting in the recognition of day-one gains or losses. ACAG agrees that such gains or losses should only be recognised when the measurements are supported by observable market inputs. However, ACAG notes that this would result in an inconsistent application of the fair value model because unobservable inputs can also be used to determine fair value, as suggested in the Basis for Conclusions (BC77).

ACAG does not believe that reference to another IFRS is appropriate in the accounting for any resulting gain or loss on initial recognition. Such accounting should be dealt with in the fair value measurement standard, as it should be a function of the measurement model, not the type of asset or liability that is subject to fair value calculations. This would enable consistent accounting for such gains and losses.

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?

ACAG believes proposed guidance about applying the various valuation techniques, such as the market approach, income approach or cost approach is appropriate but recommends the IASB consider providing additional guidance in regards to current replacement cost.

For some assets and liabilities, market information might not be available. However, the measurement objective is the same, that is, an exchange price from the perspective of a market participant that holds the asset or owes the liability. Although the exposure draft prioritises observable market inputs when they are available, an entity may have no alternative but to use unobservable inputs (Level 3 of the proposed fair value hierarchy).

When markets are not active or no longer active, measuring fair value depends on the facts and circumstances and requires the use of significant judgement. An entity will have to determine whether transactions in that market are orderly. ACAG agrees with the draft proposal that where evidence indicates that a transaction is not orderly, that little, if any, weight should be given to them. ACAG also concurs with the proposal that actual transactions that occur in an inactive market cannot be ignored by the entity.

The exposure draft proposes that valuation techniques should be applied on a consistent basis. However, a change in a valuation technique or its application would be appropriate if it leads to the value determined being equally or more reflective of fair value. ACAG supports the exposure draft proposal that such a change would be accounted for as a change in accounting estimate under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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?

ACAG notes that the proposed disclosures are prescriptive in nature, which is in contrast to the essence of paragraph 56 which suggests the preferred principles-based approach.

On disclosure, where there are a large number of Level 3 measurements, the likely effect (except for financial instruments) is that disclosures will significantly increase, which may not result in more useful information to the users of the financial statements.

In addition, ACAG notes that the additional disclosures for classes of assets and liabilities that are not measured at fair value, but for which the fair value is disclosed, are onerous and might only provide limited value to users of the financial statements.

Convergence with US GAAP

Question 12
The exposure draft differs from Statement of Financial Accounting Standards No.157 Fair Value Measurement (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?

ACAG believes that the approach proposed in the exposure draft is more appropriate than the approach in SFAS 157. However, in order to achieve a converged outcome, ACAG considers that differences from SFAS 157 should be agreed by the IASB and FASB.

ACAG has not identified any other differences that could result in significant differences in practice.

Other comments

Question 13
Do you have any other comments on the proposals in the exposure draft?

ACAG would welcome the inclusion of additional guidance that discusses restrictions on the use of assets, rather than the ability to transfer assets, particularly in circumstances where assets are held for cultural or heritage purposes, and which may be subject to restrictions as a result of public policy objectives.

The proposals contained within the exposure draft provide limited guidance on how to value equity instruments. Although paragraph 33 refers to valuation techniques for assets, expanding the guidance for valuation of equity instruments, especially where there are no observable quoted prices, would improve the determination of fair value of non-commercial equity instruments.

ACAG notes that 'transaction costs' is displayed in italics at paragraph 8 to the exposure draft, however this term is not included in Appendix A: Defined Terms.

Finally, ACAG supports the exposure draft proposal that comparative information need not be provided for reporting periods prior to the initial application of the resulting standard.