Group Finance

28 September 2009

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Canon Street
London EC4M 6 XH

Submitted electronically through the IASB Internet site (www.iasb.org)

Dear Sir David

EXPOSURE DRAFT ED/2009/5: Fair Value Measurement

Thank you for the opportunity to provide comments on this Exposure Draft (ED).

Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Stock Exchange and remains one of a select group of banks who continue to be AA rated. Our operations are predominantly based in Australia, New Zealand and Asia and our most recent annual reports reported profits of USD2.6 billion and total assets of USD376 billion.

We welcome the IASB's proposals to establish a single source of guidance for all fair value measurements and enhance the definition of fair value and related guidance.

We object to the proposed disclosure overload. Increasing the quantum of disclosure does not necessarily increase the relevance of financial information, and in fact the corollary may hold true - i.e. increased volume of disclosures can make it more difficult for users to interpret results and discern key information.

In particular, the proposed disclosures discussed in our response to question 11 do not provide decision useful information to either management or the users of the financial statements. These proposed disclosures would require significant system development as it involves data not currently captured because management does not use this information for internal review and control, so that the costs outweigh the benefits.

We recognise and share concerns over day 1 gain recognition for financial instruments with significant unobservable inputs and accordingly consider it critical that this matter is addressed and managed sensibly. Failure to deal with this issue perpetuates the current diversity of practice which should be resolved by clear guidance on when and how to incorporate uncertainty in valuation adjustments, specifically acceptable reserving practices to apply to gains and losses.

We disagree with the Board's view (paragraph BC77) that the treatment of day 1 gains or losses for financial instruments with significant unobservable inputs is an issue of when, and not how to fair value. By explicitly defining fair value as an exit price in the ED, the Board's proposal on *how* to fair value implies that day 1 gains or losses exist. Day 1 gains or losses are a function of the measurement model, not the type of asset or liability that is fair valued. The proposed approach of deferring all day 1 gains and losses lacks any theoretical merit (distinguished from day 2 gains on what basis?) and emphasises the need for practical guidance on appropriate recognition.

Finally, we appreciate the enhanced guidance regarding valuation techniques and active markets. We believe that the guidance is helpful in achieving consistency in practice on **when** it is appropriate to make adjustments to quoted prices or inputs in illiquid markets. There is a pressing need, however, for more detailed guidance on **how** to determine appropriate valuation adjustments to quoted prices to remove inappropriate bias towards the use of so-called last transaction prices.

The above documents our fundamental position. We have also taken the opportunity to provide detailed comments on the questions raised in the ED.

Should you have any queries on our comments, please contact Rob Goss, Head of Accounting Policy, Governance and Compliance at Rob.Goss@anz.com.

Yours sincerely

SHANE BUGGLE
Group General Manager Finance

Copy: Australian Accounting Standards Board (AASB)

ED/2009/5: Fair Value Measurement - Detailed answers to comment questions

We set out below our comments relating to specific questions outlined in the invitation to comment.

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?

We agree with the proposed definition of fair value in the ED.

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?

We agree with the proposed approach for the three situations. The existing IFRS measurement requirements for share-based payments, reacquired rights in business combinations and a financial liability with a demand feature are inconsistent with the proposed fair value definition.

We view it appropriate to address the issue for financial liabilities with a demand feature through a scope exception because introducing new terminology for the intended measurement of such financial instruments is potentially confusing for users in the context of the otherwise available measurement models for the broader category of financial instruments (amortised cost or fair value).

For the share based payment transactions and reacquired rights in business combinations the proposal to use terminology other than fair value does not have the potential to confuse users as these types of transactions do not roll-up to a broader class of instruments.

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 fair value measurement assumes a transaction in the most advantageous market to which the entity has access.

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 believe that the notion of market participant is adequately described in the ED. We agree with the Board's view expressed in paragraph BC43 that the market participants definition expresses a similar notion as the existing IFRS definition of fair value referring to 'knowledgeable, willing parties in an arm's length transaction'.

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?

We agree with proposal (a) because this approach is consistent with the ED's focus on a market participant based notion of fair value rather than an entity specific notion of fair value.

We believe that generally an 'in exchange' valuation premise will be appropriate for financial instruments and an 'in use' valuation premise for non-financial items and therefore agree with proposal (b). For the same reason, we agree with Board's conclusion in paragraph 24 that the in-use valuation premise is not relevant for financial assets.

We are however not convinced by the Board's reasoning in (c) with respect to liabilities. Although the Board concludes in paragraph BC52 acknowledges that an entity may be able to change the cash flows from a liability by discharging it in different ways, in the same paragraph the Board states that it does not view those as alternative uses. It is unclear to us why if (non financial) *assets* can have alternative uses, the same would not apply to (non financial) *liabilities*. This difference in approach regarding valuation premise between assets and liabilities is inconsistent with the requirement in paragraph 26 that an entity, in absence of an observable market price for the transfer of a liability, measures the fair value of that liability using the same methodology that the counterparty would use to measure the fair value of the corresponding asset. We highlight that while we believe it is appropriate to use the same methodology in the valuation of liabilities and assets, we are of the opinion that there are differences with respect to recognition of the fair value changes attributable to non performance risk. Please refer to our response to question 8.

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 do not support the proposal to separate the fair value of assets into components attributable to current use and incremental value. The proposal weakens the concept of fair value as it creates confusion about what number represents the fair value of the assets without adding considerable decision useful information.

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?

We agree with the Boards view expressed in BC69 that the fair value of a liability from the perspective of market participants who owe the liability is the same regardless whether it is settled or transferred and accordingly agree with proposal (a).

As noted in our response to question 5, we are of the view that the same valuation methodology should be used for assets and liabilities. Accordingly we agree with proposal (b).

We agree with proposal (c) as it is consistent with the ED's focus on a market participant based notion of fair value rather than an entity specific notion 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?

As noted in our comment letter to the IASB staff paper *Credit Risk in Liability Measurement*, we agree that the fair value of a liability should reflect non-performance risk. For traded financial instruments the changes in value attributable to own credit risk should be recorded in profit and loss. However, for non-traded financial liabilities that are measured at fair value, a credit related fair value movement should not be recognised in profit or loss if there is not intention or ability to realise it. For such instruments the credit component should be recognised in other comprehensive income until realised.

We agree with the proposed view that the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability. We note there is a difference between the impact of restrictions on transfers between assets and liabilities. Paragraph 5 of the ED concludes that restrictions on the sale or use of an asset should be considered in the valuation of that asset if market participants consider those restrictions. We do however believe that this difference in treatment for asset restrictions and for liability restrictions is justified mainly for the reason given in BC75. Also, as stated in FASB's ASU No. 2009-05 (section 820-10-25-16F), another fundamental difference between fair value measurement of an asset and a liability that justifies this difference in treatment, is that virtually all liabilities include a restriction preventing transfer of the liability, whereas most assets do not include a similar restriction. As a result, the effect of a restriction preventing the transfer of a liability would, theoretically, be consistent for all liabilities. However, the inclusion of a restriction preventing the sale of an asset typically results in lower fair value for the restricted asset versus the non-restricted asset, all other things being equal.

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?

We recognise and share concerns over day 1 gain recognition for financial instruments with significant unobservable inputs and accordingly consider it critical that this matter is addressed and managed sensibly. Failure to deal with this issue perpetuates the current diversity of practice which should be resolved by clear guidance on when and how to incorporate uncertainty in valuation adjustments, specifically acceptable reserving practices to apply to gains and losses.

We disagree with the Board's view (paragraph BC77) that the treatment of day 1 gains or losses for financial instruments with significant unobservable inputs is an issue of when, and not how to fair value. By explicitly defining fair value as an exit price in the ED, the Board's proposal on *how* to fair value implies that day 1 gains or losses exist. Day 1 gains or losses are a function of the measurement model, not the type of asset or liability that is fair valued. The proposed approach of deferring all day 1 gains and losses lacks any theoretical merit (distinguished from day 2 gains on what basis?) and emphasises the need for practical guidance on appropriate recognition.

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?

We generally agree with the guidance regarding valuation techniques. The guidance on determining when a market is not active and a transaction is not distressed is largely consistent with the guidance in FSP FAS 157-4 and the IASB's expert advisory panel report. This guidance is helpful in achieving consistency in practice on **when** it is appropriate to make adjustments to quoted prices. There is a pressing need, however, for more detailed practical on **how** to determine appropriate valuation adjustments to quoted prices to remove inappropriate bias towards the use of so-called last transaction prices.

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?

Although we support clear and robust disclosures which provide transparency, we are concerned about disclosure overload. In particular, we believe the following new disclosures are not beneficial on a cost benefit analysis:

- In paragraph D12 of the ED, it is proposed that day 1 profit which has been recognised upfront be disclosed, along with the level in the fair value hierarchy where the related financial instrument is categorized. We do not believe that this information is useful to users of financial statements since the instruments will be valued using observable parameters. The day 1 profit represents the ability of financial intermediaries to cross different markets and where it can be recognised upfront, the fair value measurement will be robust. This disclosure is not currently required by US GAAP and we do not believe it should be introduced into IFRS.

- Paragraph 58 of the ED requires a fair value hierarchy for instruments not held at fair value on a recurring basis to be disclosed. Due to the amendments to IAS 34 this will become a quarterly requirement. We do not believe that this is beneficial on a cost benefit analysis, as the instruments are not managed on a fair value basis.

- The disclosure regarding reclassifications between level 1 and level 2 (paragraph 57c) is not useful since the focus of fair value disclosures should be on those instruments that are difficult to value.

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?

We do not agree that divergence in treatment of day one gains for level 3 financial instruments is an improvement over SFAS 157. This is explained in more detail in our response to Question 9;

Paragraph 58 of the ED requires that a reporting entity separately disclose the fair value of instruments not carried at fair value by level in the fair value measurement hierarchy. This is not a requirement of SFAS 157 or SFAS 107 and we believe that the limited benefit that users obtain will not offset the significant costs that preparers will incur in preparing this information.

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

None