Halligan & Co

31 August 2009

Australian Accounting Standards Board
PO Box 204
Collins Street West,
Melbourne VIC 8007

Dear Sir,

Re: Exposure Draft ED181 – Fair Value Measurement

Thank you for the opportunity to provide comments on this exposure draft.

Halligan & Co is a specialist business valuation and forensic accounting practice.

Our comments on the exposure draft are generally limited to its valuation aspects rather than its accounting aspects.

We support the exposure draft and most of its proposals. However, we believe the definition of fair value needs rewording because it assumes, incorrectly, that it is possible to transfer a liability.

We have enclosed a copy of our submission to the IASB on its corresponding exposure draft. The appendix to that document contains our specific comments.

Please contact the writer if you have any queries.

Yours sincerely,
Halligan & Co

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

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Yours faithfully,
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Appendix

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?

Response:

The definition is not appropriate for the reasons given below.

(a) Cannot transfer a liability

Part of the proposed definition refers to the price that would be paid "to transfer a liability". The exposure draft (at paragraph 25) explains that "... the liability continues and the market participant transferee would be required to fulfill it; it is not settled with the counterparty or otherwise extinguished".

There is a very significant and fundamental problem with that part of the definition; which is that it is not possible to transfer a liability (except perhaps in very rare instances where there is a specific statutory provision facilitating transfer). That is because a liability is not property in the legal sense (i.e. it is an obligation rather than something capable of ownership) and, therefore, cannot be transferred.

Of course it is possible to novate a liability – but this just means extinguishing the liability of the debtor to the creditor and contractually creating a new liability (on the same terms) owed by a third party to the creditor. But that is not a transfer because a new liability has been created under a new contract. And the value of the new liability may not be the same as the value of the old liability notwithstanding that the terms are the same, if for example, the credit-worthiness of the third party is different from that of the original debtor.

It is also possible for the debtor to get an indemnity from a third party for the liability in exchange for a payment. Again there is no transfer of the liability. All that happens is that the third party assumes the economic burden of the liability, not the legal liability to the creditor.

These comments are made from the perspective of a common law legal system such as exists in Australia, the United Kingdom and the United States of America. However, we would expect that the situation in other legal systems is similar because there is a very sound economic justification for a general prohibition on transferring liabilities: i.e. otherwise debtors could avoid their obligations to their creditors by transferring their liabilities to impecunious third parties.

In our view the better concept is that of the amount for which the liability would be settled. That concept can be used to value a liability either with or without a corresponding asset (which are the two cases identified in paragraphs 27 and 28).

(b) Both the seller and buyer should be hypothetical

The concept of value adopted by valuers worldwide assumes that both the seller and buyer are hypothetical. For example, the International Glossary of Business Valuation Terms (which has been adopted by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts and the Institute of Business Appraisers) contains the following definition of Fair Market Value:

> "Fair Market Value – the price, expressed in terms of cash equivalents, at which property would change hands between a <u>hypothetical</u> willing and able buyer and a <u>hypothetical</u> willing and able seller ..." (Underlining added).

The Board says that the proposed definition (like the existing definition) assumes that "exchange transaction is hypothetical" (paragraph BC17). That does not say anything about the parties: i.e. a hypothetical transaction could be between real parties or hypothetical parties. It is unclear what position the exposure draft takes on the parties. In particular, it is unclear whether the exposure draft assumes the seller to be hypothetical or to be the reporting entity. For example, the exposure draft explains that the hypothetical transaction is to be considered from "the perspective of a market participant that holds the asset or owes the liability" (paragraph 12) and the exposure draft requires fair value to be determined using assumptions that market participants would use (paragraph 14). Prima facie this suggests a hypothetical seller. But then the reporting entity is required (paragraph 14) to consider factors specific to "market participants with whom <u>the reporting entity would enter into a transaction</u> in that market" (underling added).

We believe the definition of market participants should be amended to make it explicit that the seller and buyer are hypothetical.

(c) Exit and entry prices the same

We agree with the Board's conclusion (paragraph BC 28) that "a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market". Given that, we do not understand why the Board was concerned (paragraph BC17) that the existing definition did not specify "whether an entity is buying or selling the asset". In our view there was nothing to remedy (paragraph BC18). We believe the existing wording on this point is preferable.

(d) Better definition

For the reasons given above, we believe that market participants should be defined to be hypothetical and that a better definition of fair value would be as follows:

> "*Fair value* is the amount for which an asset could be exchanged or a liability settled in an *orderly transaction* between *market participants* at the measurement date."

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?

Response:

We have no comment.

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?

Response:

We believe that the guidance in paragraphs 8 to 11 is unclear.

More importantly, the concepts of "most advantageous market" and "principal market" are unnecessary because the value of any asset will be the highest value that can be obtained – speculators and arbitrageurs will ensure that.

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?

Response:

We believe (for the reasons given in response to Question 1) that the definition of market participants should make explicit that they are both hypothetical.

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?

Response:

Proposals (a), (b) and (c) are appropriate.

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?

Response:

The exposure draft should clarify that the incremental value is not required to be recognised or disclosed separately from the value assuming current use.

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?

Response:

See our comments about the impossibility of transferring a liability (see Question 1).

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?

Response:

See our comments about the impossibility of transferring a liability (see Question 1).

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?

Response:

We have no comment.

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?

Response:

It is not an appropriate function of an accounting standard to give specific guidance on valuation approaches, methods and procedures which are part of a large and complex body of specialist knowledge.

Paragraph 38 briefly describes three valuation approaches (although it – and paragraph BC81 – omits the fourth, the asset approach; see the International Glossary of Business Valuation Terms). It contains a collection of statements that is ad-hoc, unrelated and incomplete. As a result it provides no useful guidance. Paragraph 38 is unnecessary and inadequate and should be removed.

Similarly, Appendix C on present value techniques should be removed because it is not necessary to achieve the purpose of the proposed standard.

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?

Response:

We have no comment.

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?

Response:

We have no comment.

Question 13

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

Response:

We have the following further comments.

(a) Premises of value

The terms "in-exchange valuation premise" and "in-use valuation premise" are poorly chosen because both are based on an exchange (i.e. a sale), whereas the difference between the two is really related to whether the highest value of the asset is on a stand-alone basis or as part of a group.

Also, paragraph 23 states "Both the in-use valuation premise and the in-exchange valuation premise assume that the asset is sold individually, ie not as part of a group or assets or a business". But what about goodwill which is characterised by the fact that it attaches to a business and cannot be sold individually? Neither premise would appear to apply to goodwill – apparently with the bizarre consequence that it would have no value. We believe these terms and concepts need re-working.

(b) What does "fair" mean?

While the term "fair value" has a long history in accounting standards it is nonetheless a poor choice of words and the Board now has a rare opportunity to adopt a better form of words.

What does the word "fair" mean? There is no explanation in the exposure draft of how "fair" qualifies "value". When one reflects on this, it is a strange omission.

There are probably two main meanings of the word "fair".

One is that fair means reasonable or free from bias. Thus it might be that "fair" in "fair value" mean that the market conditions under which the hypothetical transaction are assumed to occur are in some sense reasonable or free from bias. Or maybe it means that the estimate of value made is reasonable having regard to competing evidence.

The other is that fair means just or equitable to a particular person having regard to that person's rights. This is the sense often adopted by courts in legal proceedings and in some cases by legislatures in statute law. In some jurisdictions, for example Canada, there is a body of case law about the meaning of "fair value".

Our view is that the word "fair" adds nothing useful and indeed can be misleading given that in other contexts it is used differently.

We believe a better term would be either "exchange value" or "market value" because each qualifies "value" by making it clear that it is value in an exchange transaction that is relevant.

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