Australian Government

Australian Accounting Standards Board

Level 7, 600 Bourke Street
MELBOURNE VIC 3000
Postal Address
PO Box 204
Collins Street West VIC 8007
Telephone: (03) 9617 7600
Facsimile: (03)9617 7608

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Mr Jon Nelson
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Jon

IASB Discussion Paper: *Fair Value Measurements*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on the Discussion Paper *Fair Value Measurements*. In formulating its views, the AASB sought the views of Australian constituents and its staff participated in meetings of the Fair Value Measurements Working Group of the New Zealand Financial Reporting Standards Board.

General comments

The AASB supports the IASB's initiative to develop guidance, having regard to FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) that clarifies the concept of fair value and consolidates the guidance on fair value. The AASB welcomes the IASB's consultation at this early stage of its project.

The AASB commends the IASB for using the recent work of the FASB to improve the IASB literature on fair value. The AASB considers that the Discussion Paper provides many valuable insights into the potential differences in measuring fair value under existing IFRSs compared with SFAS 157.

The AASB does not consider that SFAS 157 is readily transferable to IASB literature without detailed evaluation and a Standard-by-Standard review of its impacts on fair value measurement requirements in existing IFRSs. Fair value can be applied more widely to measure non-financial assets by IFRS-adopters than by entities reporting under US GAAP (for example, in relation to items of property, plant and equipment and biological assets), and applying SFAS 157 may have unforeseen practical implications or give rise to a need for additional guidance. A Standard-by-Standard review would greatly assist constituents to understand more of the practical implications of the IASB's proposals. Therefore, at this stage, the AASB cannot comment on the overall effect of adopting SFAS 157 as an IFRS.

Significant concerns

The AASB's significant concerns with SFAS 157 in an IFRS context are:

(a) *Fair value as an exit price.* The AASB does not support specifying fair value (as an exit price) as the only alternative to the cost basis in IFRSs, at least until the Measurement phase of the Conceptual Framework project is completed. A number of conceptual decisions will depend on the measurement objective adopted, such as whether to use entry or exit prices, whether to use market participants' expectations of cash flows or the expectations of management (as reflected in the calculation of value in use under IAS 36 *Impairment of Assets*), the unit of account to use, and the treatment of transaction costs. In relation to the first two of these choices, the AASB notes that, in some cases, exit prices might be less useful than entry prices or value in use for assessing the entity's future cash flows. The AASB is concerned that locking in the concept of fair value as an exit price would seem to pre-empt the outcome from the Measurement phase of the Conceptual Framework project, which might determine that an entry price is more appropriate than an exit price in some circumstances.

Currently, an exit price is not the only basis used in existing IFRSs when an item is revalued (refer to the response to Question 3).

The AASB considers that the term "fair value" should ultimately be replaced with terms, such as "current exit price" and "current entry price", that more closely reflect the measurement objective for each situation (refer to the response to Question 5).

The AASB's comments on the questions in the Invitation to Comment about how to measure the fair value of an asset or a liability are made only in respect of those items for which an exit price measurement is deemed appropriate. The AASB will not form a view on which items these might be until the Measurement phase of the Conceptual Framework project is progressed.

(b) *Assumptions surrounding the definition of fair value.* The AASB considers that the definition of fair value as currently expressed in SFAS 157 does not sufficiently articulate the intended concept of fair value. In addition, the Basis for Conclusions does not provide reasons for defining fair value in the chosen context (i.e. an entry or exit notion) and why the assumptions, such as those surrounding the market participant, are considered superior in determining fair value.

The AASB considers that a Standard on *Fair Value Measurements* should commence with a statement that the objective of measuring the fair values of assets and liabilities is to measure their expected future net cash inflows and outflows (respectively) in conditions of uncertainty and that, to reflect the economic reality of holding those assets or owing those liabilities, their fair values should be based on highest and best use (or, in the case of liabilities, the equivalent concept of highest and best use). It is essential that fair value measurements reflect economic reality, i.e., the most likely cash flow outcome from how the entity would deal with the asset or liability, because this provides more relevant information to users of financial statements.

(c) *Measuring non-financial liabilities at their transfer price.* The AASB agrees that the exit price of a liability should be based on the price that would be paid to transfer the liability to a market participant. However, it would be inappropriate to measure many non-financial liabilities (such as liabilities for environmental rehabilitation and for providing services under a contract with a customer) at their exit price (refer to the response to Question 9). This is an example of where applying the concept of fair value in SFAS 157 often would not reflect the economic reality of the item being measured.

(d) *Using unobservable inputs on initial recognition of an asset or a liability.* The AASB considers that when, on initial recognition, the exit price of an asset or a liability can only be determined using unobservable inputs and that price differs from the transaction price, the asset or liability should be measured using an attribute other than exit price (refer to the response to Question 11).

(e) *In-use and in-exchange valuation premises.* The AASB agrees with using the most advantageous of the in-use and in-exchange valuation premises to measure an asset's fair value. However, those terms are confusing and should be replaced with references to measuring an asset either as part of a group of assets or on a standalone basis, respectively. These replacement terms are plain English and therefore more easily understood (refer to the response to Question 17).

(f) *Blockage factors, control premiums and other portfolio effects.* The AASB considers that it is premature to resolve this issue discussed in Question 20 before the unit of account issue is considered more generally in the IASB-FASB Conceptual Framework project. It is unnecessary to explicitly prohibit taking blockage factors into account when measuring the fair value of financial instruments. Consistent with the highest and best use principle, the highest and best use of a group of financial assets or liabilities subject to blockage factors would be in-exchange (i.e., PxQ). On the other hand, a control premium may exist in relation to a position held in financial assets, and the highest and best use of those assets would be consistent with an 'in-use' valuation premise. In those situations, fair value would include the control premium.

Given that SFAS 157 does not explicitly preclude the measurement of a portfolio of financial assets or liabilities from incorporating an associated control premium, the AASB questions the appropriateness of prohibiting blockage factors when measuring financial instruments, because this might be construed as a requirement to apply PxQ in all fair value measurements of groups of items (which would preclude including a control premium in a fair value measurement). The AASB considers that this issue should be considered further before issuing an exposure draft. In addition to financial assets and liabilities, consideration should be given to incorporating portfolio effects when estimating the fair value of a group of non-financial assets and liabilities (e.g. insurance liabilities or investment properties acquired for a managed fund). Any differing treatments for financial items as compared with non-financial items should be explained in the context of the principle. Further, the IASB should avoid creating more rules or exceptions to principles (refer to the response to Question 20).

(g) *Additional guidance.* The AASB acknowledges that compared with IFRSs, US GAAP mainly restricts fair value remeasurements to financial assets and liabilities, and there are fewer circumstances in which an option or requirement to remeasure non-financial assets or liabilities at fair value exists. Therefore, the guidance in SFAS 157 is particularly relevant for financial assets and liabilities. As mentioned earlier, the AASB is concerned that it is difficult to comment on the impact of the guidance in SFAS 157 on fair value determinations in IFRSs until a Standard-by-Standard review is undertaken. For example, it is important to determine whether guidance in existing IFRSs, such as the 'reliability exemption' in IAS 39 *Financial Instruments: Recognition and Measurement* in relation to some unquoted equity instruments, which potentially conflicts with SFAS 157, should be included in the *Fair Value Measurements* Standard.

The AASB's specific comments on the questions asked in the Invitation to Comment are attached.

If you have any queries regarding any matters in this submission, please contact Natalie Batsakis (nbatsakis@aasb.com.au) or myself.

The AASB is interested in participating in a Roundtable meeting on this topic.

Yours sincerely

David Boymal.

David Boymal
Chairman

Fair Value Measurements

Specific Comments of the AASB

Introduction

The AASB provides the following responses to the IASB's *Fair Value Measurements* Discussion Paper. Its comments on how to measure the fair value of an asset or a liability are made only in respect of those items for which an exit price measurement is deemed appropriate (bearing in mind that the AASB does not support defining fair value as an exit price for all fair value measurements). The AASB will not form a view on the appropriateness of an exit price measurement objective for particular assets and liabilities until the Measurement phase of the Conceptual Framework project is progressed.

Issue 1. SFAS 157 and fair value measurement guidance in current IFRSs

> *Q1.* *In your view, would a single source of guidance for all fair value measurements in IFRSs both reduce complexity and improve consistency in measuring fair value? Why or why not?*

A single source of guidance for fair value measurements will improve its consistency, understanding and application in practice. The existing guidance is widely dispersed throughout IFRSs and is not always consistent in definition, measurement and disclosure requirements, reflecting the various stages of development of fair value principles by the IASB and its predecessor over many years. For example, in relation to fair value measurements in the absence of an active market, IAS 39 *Financial Instruments: Recognition and Measurement* paragraphs AG80-81 preclude the measurement of unquoted equity instruments at fair value when the fair value cannot be reliably determined. However, IAS 18 *Revenue*, paragraph 12, allows an alternative fair value measurement when the fair value of goods or services received cannot be reliably measured. In contrast, SFAS 157 does not contain a "reliability threshold", and therefore this potential source of inconsistency does not arise.

The concepts in measuring fair value will remain complex despite consolidating and updating the concepts into one Standard, especially when observable inputs are not available for the measurement, and particularly outside the major economies. However, these concepts should be more understandable if sufficient guidance, including illustrative examples, were included in a *Fair Value Measurements* Standard.

> *Q2.* *Is there fair value measurement guidance in IFRSs that you believe is preferable to the provisions of SFAS 157? If so, please explain.*

The AASB is not in a position at this stage to express an overall view on this issue, because the answer depends on whether an exit price notion of fair value should be applied throughout IFRSs (see the Introduction above).

The AASB notes that some guidance in IFRSs specific to particular classes of assets and liabilities is more detailed than the guidance in SFAS 157, and such guidance should be considered for retention. However, the retention of such guidance needs to be considered in a principles-based regime.

The AASB has not undertaken a thorough review of IFRSs to find guidance that should be considered for retention, but considers the following guidance would potentially be beneficial to maintain within a *Fair Value Measurements* Standard:

- IAS 39 paragraph AG82 provides examples of inputs to valuation techniques. The IASB may find it useful to expand on these examples and indicate where the inputs fall within the hierarchy.

- IAS 40 *Investment Property* paragraphs 40, 41, 43 and 50 provide fair value measurement guidance that is specific to investment property.

Issue 2. Differences between the definitions of fair value in SFAS 157 and in IFRSs

Issue 2A. Exit price measurement objective

Q3.	*Do you agree that fair value should be defined as an exit price from the perspective of a market participant that holds the asset or owes the liability? Why or why not?*

The AASB does not support specifying fair value (as an exit price) as the only alternative to the cost basis in IFRSs, at least until the Measurement phase of the Conceptual Framework project is completed. An exit price is not the only basis used in existing IFRSs when an item is revalued. For example, an exit price is not used when property, plant and equipment is revalued to fair value using depreciated replacement cost under IAS 16 *Property, Plant and Equipment*. If an entity measured such assets using the fair value basis, and acquired them immediately before the balance sheet date, measuring them at an exit price would cause an impairment loss because an exit price is the price of the next highest bidder (given that the entity that acquired the asset had the highest bid). An exit price excludes the entity holding the asset from being a market participant in relation to that asset, which could make a material difference in markets in which there are not multiple trades of homogeneous items or a limited number of competitors.

The AASB considers that the decision about which current value measurement attribute to use in measuring particular assets and liabilities should take into account the objective of current value measurements (including whether an entity's performance should be measured in terms of market participants' expectations) and the unit of account chosen for those assets and liabilities.

Q4.	*Do you believe an entry price also reflects current market-based expectations of flows of economic benefits into or out of the entity? Why or why not? Additionally, do you agree with the view that, excluding transaction costs, entry and exit prices will differ only when they occur in different markets? Please provide a basis for your views.*

The AASB considers that neither an exit price nor an entry price would accord with current market-based expectations of flows of economic benefits into or out of the entity if any of the following factors exists:

(i) the vendor or the reporting entity is not fully informed about market conditions;

(ii) the vendor is a related party that transacts on a non-arm's length basis;

(iii) the vendor is selling under compulsion; or

(iv) the "entry price" of an internally-constructed asset composes the prices of inputs, but does not capture the synergies from transforming those inputs into a composite asset.

The first three factors listed above largely reflect the guidance in paragraph 10 of SFAS 157 on the meaning of fair value.

In addition, the AASB notes that there may be instances in which entry and exit prices (excluding transaction costs) would differ in the same market. For example, entry and exit prices may differ when an asset or liability is assessed individually or as part of a portfolio, and differences in expectations about assumptions of cash flows will also result in a different entry and exit price within the same market (e.g. prepayment expectations on mortgage repayments).

Q5.	*Would it be advisable to eliminate the term 'fair value' and replace it with terms, such as 'current exit price' or 'current entry price', that more closely reflect the measurement objective for each situation? Please provide a basis for your views.*

Yes.

As mentioned in the comments on Question 3, the AASB considers that the concept of fair value as an exit price will not be appropriate for all assets and liabilities measured at current value.

The AASB regards "fair value" in existing IFRSs as an umbrella term that accommodates exit and entry prices. If "fair value" is limited to exit prices, there is no longer a purpose for using such an all-encompassing term.

In addition, the AASB notes that the plain English meaning of "fair value" is a "just" price, i.e., a price that is fair to all parties, but this is not the meaning intended. For example, a market (even if deep and liquid) may be influenced by government intervention or other "distortions", and therefore might be "unfair" to a market participant, but nonetheless provides the basis for fair value measurements. Therefore, "fair value" is an inherently ambiguous term.

For the reasons given above, the AASB considers that different terms should ultimately be used to describe the measurement attributes used, such as "current exit price", "current entry price" and "value in use". The items to which the various attributes should apply should be determined in the Measurement phase of the Conceptual Framework project, having regard to the objective of the measurement.

> *Q6. Does the exit price measurement objective in SFAS 157 differ from fair value measurements in IFRSs as applied in practice? If so, which fair value measurements in IFRSs differ from the measurement objectives in SFAS 157? In those circumstances, is the measurement objective as applied in practice an entry price? If not, what is the measurement objective applied in practice? Please provide a basis for your views.*

The AASB considers that, in various circumstances, the exit price measurement objective in SFAS 157 differs from fair value measurements in IFRSs as applied in practice. In addition to the circumstances identified in paragraph 16 of the Discussion Paper, fair value measurements using the exit price measurement objective articulated in SFAS 157 will result in different outcomes in the following circumstances:

- Current replacement cost is a technique for estimating fair value of some items of property, plant and equipment under both SFAS 157 and IAS 16. Using current replacement cost is incompatible with an exit price measurement objective, as discussed in the response to Question 3. (The detailed guidance in SFAS 157 also permits using current replacement cost as a basis for estimating fair value, and thus also departs from the exit price measurement objective enunciated in that Statement's definition of fair value.);

- As a result of excluding a reliability threshold from SFAS 157, day one gains and losses may be recognised for non-financial assets and liabilities on initial recognition, for example, where inputs (observable or unobservable) are used in valuation techniques to determine fair value and the fair value differs from the transaction price (e.g. biological assets); and

- The guidance of SFAS 157 does not prohibit portfolio measurements of non-financial assets and liabilities and therefore potentially allows portfolio effects to be estimated and included in measuring the fair value of similar assets or liabilities in a portfolio, which in practice is currently excluded under existing IFRSs (e.g. IAS 40).

Issue 2B. Market participant view

> *Q7. Do you agree with how the market participant view is articulated in SFAS 157? Why or why not?*

Yes.

The AASB considers that, because fair value measurements are market-based (not entity-specific), a fair value measurement should be based on assumptions that market participants would use in assessing the fair value of an asset or a liability.

Q8.	*Do you agree that the market participant view in SFAS 157 is consistent with the concepts of 'knowledgeable, willing parties' and 'arm's length transaction' as defined in IFRSs? If not, how do you believe they differ?*

Yes.

The only difference is that SFAS 157 articulates that market participants must be 'able to transact', which is not specifically addressed in IFRSs. However, the AASB considers that it is a clarification of the market participant's position, rather than a change to the concept of fair value in IFRSs.

The AASB notes that SFAS 157 disregards its requirement that market participants must be 'able to transact', in its use of a hypothetical transaction to measure the fair value of some liabilities that could not, or rationally would not, be settled in such a transaction (refer to the response to Question 9).

Issue 2C. Transfer versus settlement of a liability

Q9.	*Do you agree that the fair value of a liability should be based on the price that would be paid to transfer the liability to a market participant? Why or why not?*

The AASB agrees that the exit price of a liability should be based on the price that would be paid to transfer the liability to a market participant. However, it considers that it would be inappropriate to measure many non-financial liabilities (such as liabilities for environmental rehabilitation and for providing services under a contract with a customer) at their exit price. This is because an exit price for the transfer of those liabilities does not measure the estimated cost of performing those obligations—it includes a risk premium that is only incurred by the entity if it transfers those obligations today rather than extinguishing them through its own performance over time. The most likely outcome (economic reality) is that the entity will not transfer the liability and incur the risk premium, i.e., applying the equivalent of highest and best use to liabilities results in using the lower price to settle the obligation over time in the ordinary course of business, which does not include a risk premium.

The AASB considers that measurements of such liabilities will be more relevant to users of financial statements if they reflect the entity's estimated future cash outflows from extinguishing the obligations itself (rather than from transferring them to another entity), particularly because most non-financial liabilities are extinguished by an entity's own performance. In addition, many non-financial liabilities do not have markets for their transfer to other entities, and determining their exit prices often involves highly subjective estimates that would provide less relevant information to users of financial statements.

In summary, the AASB considers that if liabilities were measured using an equivalent concept to highest and best use (i.e., having regard to economic reality), it would not be based on a "transfer at the measurement date" notion.

Q10.	*Does the transfer measurement objective for liabilities in SFAS 157 differ from fair value measurements required by IFRSs as applied in practice? If so, in practice which fair value measurements under IFRSs differ from the transfer measurement objective in SFAS 157 and how do they differ?*

Yes.

The AASB notes that IAS 39 defines the fair value of a financial liability as the amount for which the liability could be *settled*, between knowledgeable willing parties, in an arm's length transaction (paragraph 9, emphasis added).

In addition, paragraph 49 of IAS 39 specifies that the "fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid." Applying a 'transfer' notion to such liabilities will result in a different fair value from that resulting from applying a 'settlement' notion because, under a transfer notion, discounting occurs over the typically longer period to when the market expects repayment to occur. In contrast, under IAS 39 paragraph 49, discounting only occurs up to the first date that the amount could be required to be paid (i.e., "settled").

Issue 3. Transaction price and fair value at initial recognition

Q11.	*In your view is it appropriate to use a measurement that includes inputs that are not observable in a market as fair value at initial recognition, even if this measurement differs from the transaction price? Alternatively, in your view, in the absence of a fair value measurement based solely on observable market inputs, should the transaction price be presumed to be fair value at initial recognition, thereby potentially resulting in the deferral of day-one gains and losses? Please give reasons for your views.*

The AASB agrees with the comment in paragraph 17 of SFAS 157 that, in many cases, the transaction price will equal the exit price (fair value) of an asset or a liability on initial recognition. However, the AASB considers that when, on initial recognition, the exit price of an asset or a liability can only be determined using unobservable inputs and that price differs from the transaction price, that asset or liability should be measured using an attribute other than exit price. Day one gains and losses should only be recognised when the measurements are supported by observable market inputs.

Q12.	*Do you believe that the provisions of SFAS 157, considered in conjunction with the unit of account guidance in IAS 39, would result in a portfolio-based valuation of identifiable risks of instruments considered in aggregate, or an in-exchange exit price for the individual instruments? Please give reasons for your views.*

The provisions of SFAS 157, considered in conjunction with the unit of account guidance in IAS 39, would result in an in-exchange exit price for individual financial instruments.

The provisions of SFAS 157 require the entity to determine the asset's highest and best use (i.e. either "in-use" (in aggregate with other assets) or "in-exchange" (standalone)) and provide the example within paragraph 13(b) suggesting that the highest and best use of a group of financial assets will be based on the in-exchange valuation premise (see the response to question 20). This is supported by paragraph 27, which states that the "fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held."

IAS 39 paragraph AG72 states that "the fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted price", which is consistent with paragraph 27 of SFAS 157.

The AASB recommends clarification of a potential conflict between paragraph 27 of SFAS 157 (quoted from above) and paragraph 25 of that Standard. Paragraph 25 includes "If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method ...". It is not clear why a quoted price "...might be available but not readily accessible...". Some might construe this as a reference to the existence of a blockage factor, and therefore that paragraph 25 allows blockage factors to be taken into account.

Issue 4. Principal (or most advantageous) market

Q13.	*Do you agree that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability? Why or why not?*

Yes.

Whilst the principal market may not provide the most advantageous measurement, it is preferable for the entity to make reference to the principal market in the first instance for a number of reasons:

- market participants will most likely have access to that market at the transaction date;
- the principal market is most likely to provide measures that assist assessments of the entity's future cash flows, as this is the likely market in which a transaction for the asset or liability will occur;
- using the principal market will not require the entity to incur undue cost or effort in searching for the most advantageous market; and
- the principal market will provide a more relevant and verifiable measurement of fair value if the asset or liability is traded regularly.

Issue 5. Attributes specific to the asset or liability

Q14.	*Do you agree that a fair value measurement should consider attributes specific to the asset or liability that market participants would consider in pricing the asset or liability? If not, why?*

Yes.

Considering the specific attributes that market participants would consider in measuring the fair value of assets or liabilities is consistent with the notion of fair value articulated in SFAS 157 because these are key considerations in determining the amount a market participant would pay for an asset or receive for assuming a liability, and therefore in assessing fair value.

Q15.	*Do you agree that the transaction costs that would be incurred in a transaction to sell an asset or transfer a liability are an attribute of the transaction and not of the asset or liability? If not, why?*

Yes.

SFAS 157, paragraph 9, describes transaction costs as incremental direct costs to sell an asset or transfer a liability and states that transaction costs exclude costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. These latter costs are an attribute of the item being measured, and the AASB agrees with their inclusion in fair value measurements.

Issue 6. Valuation of liabilities

Q16.	*Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value of a liability? If not, why?*

As indicated in its comments on Question 9, the AASB considers that it would be inappropriate to measure many non-financial liabilities using an exit price measurement objective. However, the AASB also considers that, when liabilities *are* measured at fair value using an exit price measurement objective, the risk of non-performance (including credit risk) should be considered in measuring that value.

Issue 7. 'In-use valuation premise' versus 'value in use'

Q17.	*Is it clear that the 'in-use valuation premise' used to measure the fair value of an asset in SFAS 157 is different from 'value in use' in IAS 36? Why or why not?*

The AASB considers that various readers may confuse the phrase 'value in use' in IAS 36 (which reflects management's expectations regarding future cash flows) with the 'in-use valuation premise' terminology in SFAS 157 (which reflects the expectations of market participants about future cash flows from the highest and best use of the asset as part of a group of assets).

A *Fair Value Measurements* Standard would be more understandable if the 'in-use' and 'in-exchange' valuation premises, referred to in SFAS 157, were renamed to articulate their plain English meaning – i.e., determining the highest and best use of an asset either as part of a group of assets or on a standalone basis, respectively.

In respect of the in-use valuation premise, the AASB considers that further guidance should be provided regarding:

- how the fair value measurement of a group of assets is allocated to the individual assets within the group; and

- the appropriate level of aggregation of assets used when a cash-generating unit to which an asset belongs is part of a larger cash-generating unit. This issue arises because the synergies created by a group of assets will normally increase with the addition of more assets and, therefore, the higher the level of aggregation, the greater the fair value attributable to each asset within the larger group.

In relation to these issues, the AASB notes that Example 1 of Appendix A to SFAS 157 indicates that the asset groups chosen are those that maximise the value of each group. Typically, this would mean estimating the fair value of each business and allocating the value of the business to its component assets. The AASB recommends that the IASB clarifies whether that is the meaning intended.

Issue 8. Fair value hierarchy

Q18. Do you agree with the hierarchy in SFAS 157? If not, why?

The AASB agrees that inputs to a fair value measurement should be ranked in terms of their relative reliability or faithful representation, and considers that the fair value hierarchy in SFAS 157 generally ranks the inputs appropriately. The fair value hierarchy is a useful tool to assist users of financial statements to understand the quality of the inputs used for fair value measurements in financial statements.

However, the AASB considers that Level 1 of the hierarchy should not be limited to quoted prices in active markets for identical assets or liabilities. Level 1 should also include all observable inputs for the asset or liability, as referred to in paragraph 28(c) of SFAS 157 (e.g. interest rates and yield curves observable at commonly quoted intervals, and prepayment speeds).

Prices that are not current should be excluded from Level 2 of the hierarchy (see paragraph 28(b) of SFAS 157), because these prices should not be ranked above unobservable inputs in Level 3.

Q19. Are the differences between the levels of the hierarchy clear? If not, what additional information would be helpful in clarifying the differences between the levels?

The AASB considers that, in general, the differences between the levels of the fair value hierarchy are clear. However, it recommends that the IASB considers the following:

- Level 3 of the hierarchy needs to be further developed with examples and scenarios to assist preparers and users of financial statements with its application, especially where fair value measurements primarily using unobservable inputs on day one provides a different value from the transaction price; and

- as mentioned in response to Question 2 above, it may be useful to provide illustrative examples of the types of inputs found in each level of the hierarchy, especially those inputs that fall into Levels 2 and 3.

Issue 9. Large positions of a single financial instrument (blocks)

> *Q20. Do you agree with the provision of SFAS 157 that a blockage adjustment should be prohibited for financial instruments when there is a price for the financial instrument in an active market (Level 1)? In addition, do you agree that this provision should apply as a principle to all levels of the hierarchy? Please provide a basis for your views.*

The AASB considers that it is premature to resolve this issue before the unit of account issue is considered in the IASB-FASB Conceptual Framework project. The AASB disagrees with explicitly prohibiting a blockage adjustment for financial instruments.

The AASB considers blockage factor adjustments to be inconsistent with the highest and best use principle. However, it is unnecessary and inappropriate to prohibit blockage factors because the highest and best use principle will automatically exclude blockage factors from the fair value measurement of a group of assets. For example, the fair value of a group of financial assets affected by a blockage factor would be measured using the 'in-exchange' valuation premise (i.e., on an individual basis using the market price of a single instrument times the number of instruments held ("PxQ")). This is because a blockage factor, arising due to the size of the block held relative to the trading volume in the market, would reduce the total value of the group. A reduction in the value of the group would contradict the highest and best use principle and therefore prevent measurement of the group using an 'in-use' valuation premise.

On the other hand, when a control premium exists in relation to a group of interests (e.g., equity instruments) held in another entity or an operation, the highest and best use of those assets would be consistent with an 'in-use' valuation premise. Fair value would include the control premium. Therefore, the AASB considers that whether financial assets are measured on a PxQ basis is dependent on the highest and best use principle. The AASB is concerned that an explicit prohibition of blockage factors might be construed as a rule to always measure financial assets at PxQ, which would be inappropriate and inconsistent with principles-based Standards.

For consistency, the decision to prohibit or allow blockage factors and control premiums should apply to all levels of the hierarchy because its rationale is equally applicable to inputs that fall within Levels 2 and 3 of the hierarchy.

In addition to financial assets and liabilities, consideration should be given to the appropriate unit of account for estimating the fair value of similar non-financial assets and liabilities in a portfolio (e.g. insurance liabilities or investment properties acquired for a managed fund). The risk diversification increases the selling value of such properties when they are grouped in the portfolio and, as such, the highest and best use is consistent with an 'in-use' valuation premise, which incorporates portfolio effects. In an exit price model of fair value, market participants would consider portfolio effects of groups of non-financial assets and liabilities in determining fair value.

Regardless of the approach taken by the IASB, the AASB considers it appropriate that, within a principles-based regime, the guidance issued in respect of blockage factors, control premiums and portfolio effects should be consistent for financial items and non-financial items and for measurements that fall within any level of the hierarchy.

Issue 10. Measuring fair value within the bid-ask spread

Q21.	*Do you agree that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances, as prescribed by paragraph 31 of SFAS 157? Alternatively, do you believe that the guidance contained in IFRSs, which generally requires assets to be valued at the bid price and liabilities at the ask price, is more appropriate? Please explain the basis for your view.*

The AASB considers that an entity should determine the price within the bid-ask spread that is most representative of fair value, when it is not impracticable to do so. The AASB recognises that, sometimes, determining fair value measurements using the price within the bid-ask spread that is most representative of fair value may result in assets being valued at bid prices and liabilities at ask prices. However, this should be determined with regard to the circumstances of each measurement.

Q22.	*Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed even when another price within the bid-ask spread might be more representative of fair value? Why or why not?*

No.

Fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value. This may mean that the fair value of an asset or liability will be equal to the mid-market price, the bid price for assets or the ask price for liabilities. Allowing a pricing convention to be applied when other prices that are more representative of fair value can be obtained would undermine the faithfulness of the measurement.

However, the AASB considers that the provisions of SFAS 157 paragraph 31 are appropriate in allowing pricing conventions when the price most representative of fair value within a bid-ask spread cannot be assessed within reasonable cost-benefit constraints.

Q23.	*Should bid-ask pricing guidance apply to all levels of the hierarchy, including when the fair value measurement includes unobservable inputs? Why or why not?*

Yes.

As discussed in Question 20 above, the AASB considers that fair value measurement guidance should be consistent for all levels of the hierarchy, including measurements that include unobservable inputs. Given SFAS 157 does not have a reliability threshold, then the bid-ask pricing guidance should apply to all levels of the hierarchy set out in SFAS 157, including:

- Level 2 – where there may be a bid-ask spread for similar items; and
- Level 3 – where some entities may indirectly compute or infer a bid-ask spread even if not observable (as noted in IASB DP paragraph 50).

In a principles-based regime, different rules should not be attributed to different levels of the hierarchy.

The entity should make reasonable assumptions in assessing the value that best represents fair value within a range of values and, where this cannot be determined, SFAS 157 does not preclude the use of pricing conventions such as mid-market pricing as a practical expedient for fair value measurements within a bid-ask spread.

Issue 11. Disclosures

Q24.	*Do the disclosure requirements of SFAS 157 provide sufficient information? If not, what additional disclosures do you believe would be helpful to users and why? Alternatively, are there disclosures required by SFAS 157 that you believe are excessive or not beneficial when considered in conjunction with other disclosures required by IFRSs? Please provide a basis for your view.*

Until a disclosure framework is developed, the AASB cannot make an overall assessment of how detailed the disclosures about fair value measurements should be. In that context, the AASB has the following tentative views.

The AASB considers that adding the disclosure requirements in SFAS 157 to those in existing IFRSs would result in excessive disclosures. It considers that disclosure requirements about fair values should be contained in one Standard, rather than dispersed throughout IFRSs.

The AASB considers that disclosure requirements about changes in valuation techniques should be the same for interim periods as for annual periods, and the same for recurring and non-recurring fair value measurements. It notes that this is not the case in SFAS 157. SFAS 157 has different disclosure requirements about changes in valuation techniques applied to measure the fair value of assets or liabilities, at interim and annual periods (see paragraphs 32 and 33). In addition, SFAS 157 requires disclosure, in respect of assets and liabilities that are measured at fair value using significant unobservable inputs (Level 3), of a description of the inputs and the information used to develop the inputs, but only when those assets and liabilities are measured at fair value on a non-recurring basis.

Recommended additional disclosures

To achieve consistency between disclosures in interim and annual periods, the AASB recommends requiring the following disclosures when there has been a change in a valuation technique applied to measure the fair value of assets or liabilities in an interim period:

- the valuation technique applied at the prior period end; and
- the impact of the change on the financial statements.

The AASB notes that SFAS 157, paragraph 32, requires various disclosures of gains and losses (realised and unrealised), in respect of fair value measurements using significant unobservable inputs (Level 3). However, it does not require similar disclosures of gains and losses (realised and unrealised) in respect of fair value measurements using Level 1 and Level 2 inputs. The AASB considers this is anomalous and provides incomplete information about the evidence supporting fair value gains and losses. Therefore, the disclosure requirements regarding fair value gains and losses should apply to each level of the fair value hierarchy.

Recommended omissions of disclosures

The AASB regards the disclosures in paragraphs 32(c)(2) and (3) of SFAS 157 to be excessive. A reconciliation of the beginning and ending balances of items measured at fair value using Level 3 inputs is unlikely to be useful to many users of financial statements, but would increase the detail of disclosure in the financial statements.

Other issue

The AASB considers the aggregation level of the disclosure requirements detailed in paragraph 32(c) of SFAS 157 is unclear. As it currently reads, it may be interpreted as being too onerous and will not be any more useful to users of financial statements than such information disclosed at a higher level of aggregation (e.g. Financial Assets, Available-for-Sale Assets, Property, Plant and Equipment, etc) and information provided in the Cash Flow Statement. The AASB recommends that the IASB clarifies the level of aggregation required for this disclosure.

Issue 12. Application guidance

Q25.	*Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply under IFRSs? If not, please specify what additional guidance you believe is needed and why.*

The AASB generally considers that the guidance in Appendices A and B of SFAS 157 sufficiently illustrates the Standard's principles and provisions. However, it would be premature to express a firm view on this issue before a Standard-by-Standard review of the implications of SFAS 157 is performed. Nevertheless, the AASB considers that some additional guidance in the following areas may be useful to users of a Standard on Fair Value Measurements:

Example 2 in Appendix A

This example is not clear regarding whether the fair value measurement of the land should take into account the potential value of the land used in an alternative use in the future (e.g., in 5 years time). Property valuers take into account the potential value of the land used in an alternative use in the future and the related probability when valuing land at its highest and best use.

Example 9 in Appendix A

This example does not state whether the entity has the right to sell the land. It would be helpful if the example clarified this matter because this is an important factor in determining the fair value of the land.

In addition to the above issues, the guidance in respect of the following issues would help readers apply the Standard:

Cash flows

A common issue raised by constituents is whether pre-tax or post-tax cash flows should be used when using discounted cash flow to determine fair values. Prices for exchanges of assets and liabilities generally reflect post-tax cash flows and discount rates. The AASB considers that the forthcoming guidance on fair value should state whether pre- or post-tax cash flows and discount rates should be used and, if the latter applies, whether the tax rate should be that of the market participant with the lowest tax rate.

Non-financial assets and liabilities

The AASB notes that there are relatively few circumstances in which non-financial assets or liabilities are remeasured at fair value under US GAAP. As such, the guidance will need to be further developed in respect of the measurement of non-financial assets and liabilities and items for which a deep and liquid market does not exist (such as energy infrastructure).

Other additional guidance recommended by the AASB is mentioned in the responses to Questions 17 and 19.

Q26. Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply in emerging or developing markets? If not, please specify what additional guidance you believe is needed and the most effective way to provide this guidance (for example, through additional implementation guidance or through focused education efforts).

The AASB considers that this issue is generally not applicable to Australian constituents. Whilst some Australian constituents have operations in emerging markets, the AASB considers that the IASB will generally receive more useful input on Question 26 from organisations domiciled in those markets, than from the AASB. However, the AASB considers that those applying a *Fair Value Measurements* Standard in emerging or developing markets would benefit from further guidance on Levels 2 and 3 of the fair value hierarchy, particularly in respect of markets that are not active and liquid.

Issue 13. Other matters

Q27. Please provide comments on any other matters raised by the discussion paper.

Comments on some aspects of SFAS 157

Paragraph 12 of SFAS 157 describes the highest and best use of an asset as one "that is physically possible, legally permissible, and financially feasible at the measurement date." The AASB considers that the meaning of "legally permissible" should be clarified. For example, does it mean that the fair value of land must be based on the existing zoning that applies to that land? If it did, it would contradict the behaviour of market participants to price land in a market exchange by taking account of the enhanced cash flows that would result from a potential favourable rezoning and the probability of that rezoning occurring.

In addition, the AASB considers that the meaning of "financially feasible" should be clarified. For example, some might think that a potential use of an asset is not financially feasible if it conflicts with management's intentions. The AASB considers that this is not the meaning intended by "financially feasible", and that this point should be clarified. Another aspect of this term requiring clarification is whether, if sale of an asset is its highest and best use, the sale price should be the realisable amount of the asset. Such an interpretation would appear to be inconsistent with the assumption in SFAS 157 of an adequate marketing period having already occurred (if marketing has not in fact occurred before the measurement date) and with the treatment of blockage factors in SFAS 157 (paragraphs 7 and 27, respectively). However, because there is a widely held view that the objective of current value measurements (including fair value measurements) is to represent the realisable value of the assets and liabilities, the AASB recommends that the IASB clarifies its position on this issue.

The last sentence of paragraph 18(c) of SFAS 157 says, "Obsolescence … is broader than depreciation for financial reporting purposes (an allocation of historical cost) …". The AASB disagrees, because depreciation is not limited to historical cost measurement (i.e., when property, plant and equipment is revalued to fair value, it is still to be depreciated).

Paragraph A10 of Appendix A refers to land used as a site for a manufacturing facility. However, discussing the same parcel of land, paragraph A11 refers to a manufacturing *operation*, which is potentially confusing. The AASB considers that in paragraph A11, this reference should be made to the facility to which the land belongs.

Paragraph C40 of Appendix C says "… the Board agreed that the fair value of the liability from the perspective of a market participant is the same *regardless of how the reporting entity intends to settle the liability*" (emphasis added). These italicised words could be misconstrued as a reference to regardless of which market (e.g., the principal market) the reporting entity intends to use to settle the liability. The AASB considers that the italicised words should be replaced with "regardless of whether the reporting entity decides to settle the liability using its own internal resources".