The Association of Corporate Treasurers

Comments in response to

Discussion Paper on fair value measurements

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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. In preparing this response we receive views and reactions from our members via our Committee structure. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

General

The ACT welcomes the opportunity to comment on this matter.

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The objective of the Discussion Paper (DP) is stated to be "establishing a single source of guidance for all fair value measurements required by IFRSs". However the paper then goes on to follow the US standard SFAS 157 and broadly speaking tries to establish a single definition of fair value. A single source of *guidance* could be a useful reference document while a single *definition* of fair value would be most unwelcome and could lead to misleading values appearing in accounts.

The determination of a fair value depends on the context and use to which that value will be put. We do not see the need to standardise the definition of fair value and to apply a single definition in inappropriate circumstances.

If fair values are to be used in a meaningful way in accounting the definition should depend on the purpose for which it is being used. That said it could be helpful to establish a hierarchy of preferred methodologies. As a company moves down the list to find the most appropriate definition it would need to justify itself to its auditors.

There appears to be an aim to set down a definition that will remove subjectivity and produce more reliable measurements, and to achieve this the IASB has settled on market based measures. However we do not think that this will necessarily achieve the objectivity desired since it requires an assumption that a liquid market exists and that there are willing buyers and sellers. Very often this will not be the case.

Your introduction explains that this tendency towards market participant exit values is driven by a desire to eliminate US reconciliation statements for non US companies registered in the US. While we welcome the objective of eliminating the need for reconciliations we question whether it is right to move headlong towards the US formulation of fair value.

What seems to be missing from the DP is any discussion of any overriding objective or principle and indeed whether it is possible to generalise to find an objective applicable in all circumstances. The DP follows SFAS 157 and chooses a market based value taken from the perspective of a market participant rather then the alternative of looking at values from the point of view of the entity. We hope that in your further roundtable meetings you can explore whether the purpose of using fair values is to find a net realisable value of an asset or liability or rather to find an entity specific value in use sort of valuation.

We can identify three traditional principal valuation bases depending on the use required:

- Market value
- Replacement cost
- Value in use

It may be appropriate for any guidance to indicate which basis is appropriate for which standard and then to offer a hierarchy of preferences or methodologies within each category.

We realise that this DP is not proposing any new circumstances or standards where fair values will be required. However we have noted that the use of fair values is becoming more widespread even to the extent that some users suspect that the IASB is heading towards measuring company performance as the difference in the full fair value of the opening and closing balance sheets rather than by reference to recording the transactions undertaken by the entity during the year. Fair values definitely have their place in corporate finance for assessing acquisition or disposal values of companies or businesses but we deprecate their extensive use in financial accounting. We see accounts as measuring the activity and performance of an entity rather than its market value. However for the purposes of this response we will refrain from questioning their use in existing standards.

Many of the specific questions concern market based measurements. Our comments on market methodologies in the following responses are based on the assumption that the circumstances require a market based method. As noted above we do not believe a market based method is universally applicable.

Specific Questions

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

Question 1: 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?

A1: A single source of Guidance could be useful but this should not mean that there must be a single definition of fair value.

Question 2: Is there fair value measurement guidance in IFRSs that you believe is preferable to the provisions of SFAS 157? If so, please explain.

The guidance on fair values in IFRS is scattered around the relevant standards, which does have the merit that it is tailored to the context and is therefore more meaningful. If general guidance is to be produced it should ideally be more principles based in order to set the framework by which the standard by standard methodologies can be set.

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

Question 3: 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?

A3: As described in the general section above we do not consider that a market based exit value is appropriate in all circumstances.

Where a market value is required then the exit value from the point of view of a market participant that holds the asset would be fine if the purpose is to produce a set of valuations for a liquidation but more normally the shareholders are interested in going concern accounts so that exit values can be of little relevance. For financial instruments tradable in a liquid market and where those instruments are not 'essential' to allow the business to continue an exit price would be reasonable. The important point is what gives the most useful information to users of the accounts.

If determining the need for any impairment write down the exit value is irrelevant, since the important fact is what income is the asset capable of producing in use in the specific entity. Using a market participant exit value should not be used as a universal basis for fair values but can be used as one of the options.

SFAS 157 states that an exit price objective aims 'to embody current expectations about the future inflows associated with the asset and the future outflows associated with the liability from the perspective of market participants.' Presumably this is an attempt to establish a degree of objectivity but it assumes that the market has full information which often it will not. The seller of a second hand car may know that it has been 100% reliable and is running well while the market participant cannot be certain of this and will pay a discounted price to reflect this. Where there is not a good market you have to rely on assumptions which weakens the objectivity. If you assume the market participant has full information then effectively you are in any case coming back to an entity specific view.

Question 4: Do you believe an entry price also reflects current market-based expectations of flows of economic benefit 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.

A4: At any instant for a given transaction the exit price will equal the price at which the buyer buys, ignoring transaction costs. However the market price will be set by either the buyer or seller depending on market supply and demand. The value of a bunch of flowers will be set as the florist's exit price early in the day but later on when the florist is desperate to dispose of their stock the market price will be set by the price a buyer is prepared to give to enter and make the purchase. In each case the value of the flowers to the florist will still be the exit price.

There is a further complication in that for many tradable items there are several different markets. This same bunch of flowers bought in quantity in a wholesale market will have a very different price so the florist's entry price in the wholesale market will be different from their exit price in the retail market.

Question 5: 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.

A5: The widespread public debate engendered from this DP demonstrates that 'fair value' is not a particularly useful term since so much uncertainty surrounds its determination. We believe that a term that better reflects the measurement objective of each situation or standard would be preferable.

Question 6: 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 IFRS differ from the measurement objective 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.

A6: The exit price methodology in SFAS 157 is broadly appropriate for valuations of financial instruments where good, liquid markets tend to exist. However for most of the other circumstance in IFRS where 'fair value' is required the circumstances are rather more orientated towards some form of entity specific calculation of value. In doing that entity specific calculation the creation of some sort of hierarchy for determining the assumptions to be used in that calculation or modelling could be helpful and for that purpose something similar to the three level hierarchy in SFAS 157 would be worth exploring.

Question 7: Do you agree with how the market participant view is articulated in SFAS 157? Why or why not?

A7: The market participant view in SFAS is fine if there is a good and liquid market, but if this does not exist there will immediately be weaknesses. If there are no markets or multiple and disparate markets the logic breaks down. Once one has to assume hypothetical markets the outcomes can no longer be treated as particularly objective or unbiased and another basis which is entity specific can be better fit for purpose.

Q*uestion 8: 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?*

A8: We agree that these two concepts are in essence consistent

Question 9: 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?

A9: As with all the questions raised by this DP the valuation basis should depend on the purpose of the valuation. Where a market based value is the objective and is possible, then the transfer value is appropriate, and will inevitably take into account the possibility of an entity specific settlement amount. Where a value in use type of value is required then the entity specific settlement amount is preferable.

Question 10: 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?

A 10: If a liability is tradeable and a liquid market exists the SFAS 157 methodology can readily be applied in practice. However if a liability is not in the form of a tradable financial instrument the norm would be to record values based on settlement values.

Issue 3: Transaction price and fair value at initial recognition

Question 11: 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.

A11: Transaction price will normally be the appropriate fair value at initial recognition unless there is an over-riding objective to show value for a different purpose. Looking at the accounts from the perspective of a user it is hard to see why the potential for any day one profits in moving the purchased item from one market to a different market with a higher price should be recognised until they are realised or certain.

Question 12: 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.

A12: The unit of account for valuing assets or liabilities, ie whether or not to group assets and /or liabilities, is important so as to ensure consistency and usefulness. SFAS 157 allows for the unit of account to be determined by other accounting pronouncements so is unlikely to disturb the logic in IAS 39 which determines values instrument by instrument and for compound instruments splits the instrument into component parts.

Issue 4: Principal (or most advantageous) market

Question 13: 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?

A13: On this point SFAS 157 takes an unusually pragmatic view that valuations can be taken from the principal market and that the reporting entity does not have to monitor the markets continuously to determine the most advantageous market. We welcome this approach even though we note that in other areas the FASB attempts to create a degree of accuracy that we see as spurious, while in this area they are content to allow the potential for a small inaccuracy.

Issue 5: Attributes specific to the asset or liability

Question 14: 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?

A 14: Where a market based fair value is to be used it seems wholly appropriate to consider the attributes specific to the asset of liability that the market participants would consider, however there will be other circumstances where a valuation which comes from the entity perspective is more appropriate.

Question 15: Do you agree that 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?

A15: We agree that the transaction costs are an attribute of the transaction and not of the asset or liability. However since much of SFAS 157 is aimed at determining a market based exit value we are puzzled that transaction costs are not allowed for in creating this sort of net realisable value.

Issue 6: Valuation of liabilities

Question 16: 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?

A 16: Opinions are divided on whether adjusting the value of an entity's own liabilities for changes in its own credit risk provides the user with more or less useful information. It is unclear whether the IASB is proposing that changes in valuation caused by credit enhancements should be allowed for, or whether all changes in credit standing should be allowed for, which would be a very different approach to that current in IAS 39. The argument 'for' is that it genuinely reflects the market based value of a liability. The argument 'against' is that it creates the counter intuitive outcome that an entity heading towards financial distress will show a profit on its own liabilities. We favour the exclusion of changes in value due to the entity's own credit standing.

Issue 7: "In-use valuation premise" versus "value in use"

Question 17: 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?

A 17: It is clear that "in-use valuations" in SFAS 157 come from the market participants view of use and is therefore different from the IFRS "value in use" which is an entity specific view. This question brings out the nub of the problem with applying the FASB approach to circumstances it was not intended for. Is the valuation to be used as a disposal value or is it rather that the asset is intended to be retained and can create cash flows within the business as is done for IAS 36 impairment calculations?

Issue 8: Fair value hierarchy

Question 18: Do you agree with the hierarchy in SFAS 157? If not, why?

A18: On the assumption that one is seeking a market based value from the market participant's point of view the concept of a hierarchy to prioritise the inputs to that valuation is helpful and we agree with the order of priority in SFAS 157. Some sort of similar hierarchy for assessing an entity specific value would also be helpful.

Question 19: 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?

A19: In principle the differences in the three levels in the hierarchy are clear, although there will no doubt be some blurring of the distinctions in practice.

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

Question 20: 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.

A20: To obtain a clearly determinable market based valuation it is possible to use a unit of account that is broken down to individual items and then multiply by the number of items, and this is the SFAS 157 approach. This is certainly an easier approach than determining a blockage or controlling effect for large holdings. The US approach is surprisingly pragmatic here. Since much of the US market based approach seems directed at finding a realisable value we would expect that the effects of disposing of a large block of assets or liabilities, positive or negative, would be allowed for.

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

Question 21: 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.

A21: The requirement in SFAS 157 to use “the price within the bid-ask spread that is most representative of fair value in the circumstances” seems to us to be a practical expedient and reflects the fact that bid-offer spreads can vary depending on the entity involved even in the same market and for similar sized transactions. Where bid-offer spread is particularly large the effect does become a substantial transaction cost so we would expect a treatment consistent with the outcome on Q15 above.

Question 22: Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed when another price within the bid-ask spread might be more representative of fair value? Why or why not?

A22: We suspect that for most liquid markets this question is getting into a level of detail that could be left to the discretion of the preparer. Using the price that is that is “most representative of fair value in the circumstances” provides reasonable flexibility here.

Question 23: 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?

A23: At lower level in the hierarchy there will be some significant assumptions made. Some flexibility to use the most representative bid-ask pricing in the unobservable inputs would be reasonable.

Issue 11: Disclosures

Question 24: 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.

A24: If fair values are being used users will want to understand the full effects and the assumptions used. The disclosures specified in SFAS 157 look to be providing a full explanation to users but at the risk of being excessive. If the use of fair values has to be hedged around with such extensive explanations and reconciliations we suspect that most users will be thoroughly confused and that it will not help in providing users with useful information.

Issue 12: Application guidance

Question 25: 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?

No comment

Question 26: 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).

No comment

Conclusion

The entire theme of the DP is that there should be a set of rules to determine a precise fair value. We are not convinced that there needs to be precise comparability in accounting. A principles based set of standards should allow for the fact that there may be a slight variation in possible outcomes, while making sure that the extremes or more outrageous approaches are outlawed.

The Association of Corporate Treasurers

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Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestosept2006.pdf.

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