Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2009:21

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

Re: Exposure Draft - ED/2009/5 - Fair Value Measurement

This is the Swedish Financial Reporting Board´s response to the invitation to comment on the Exposure Draft (ED) of the Fair Value Measurement standard.

As measurement is used for so many different situations, responding to the ED should not be done only focusing on how to measure in isolation. The proposals have to be evaluated from the view of when to measure, in order to make it possible to consider and evaluate the usefulness of financial information the proposals will lead to.

We support much of what is included in the ED. However, when we in the response below refer to fair value, we thereby mean a measurement to be used, where the intended use of the asset or liability is to sell rather than use, or situations where an exit price is a reasonable estimate for a current value when using the asset or liability, rather than exchanging or transferring. Commenting on the ED, the starting point for us is that the forecasting objective is the most important objective for a measurement standard.

The proposed definition

We support the proposed new definition of fair value, to be used under the label "Exit price", but we think it should be expanded to also cover equity instruments issued. In the ED, but not in the SFAS 157, guidance for measurement of the fair value of equity instruments issued by the reporting entity is included. We believe that as a consequence, measurement of fair value of equity instruments issued by the reporting entity should also be included in the fair value definition, as in the old definition.

The proposed guidance, to which we object

Exit price

BC28 includes the IASB´s rational for defining fair value as a current exit price. It states *"As a result of the standard-by-standard review, the Board concluded 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. Therefore, the Board*

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considered it unnecessary to make a distinction between a current entry price and a current exit price in IFRSs with a market-based measurement objective (ie fair value), and decided to define fair value as a current exit price." We believe that the IASB should expand this part of the BC and more clearly explain when and why entry and exit prices are equal and why fair value should be defined as exit and not entry price. The current explanation in BC28, does not in a clear and understandable way describe the IASBs thinking behind this important part of the definition.

The IASB also should revisit the foot note to BC 28 that states; "Some have questioned the assertion that entry and exit prices are equal in those situations, citing bid-ask spreads as a potential difference between entry and exit prices in the same market. In reaching its conclusion, we acknowledged that such a difference could exist but attributed any such difference to transaction costs, which are not included in the price when measuring fair value." The IASBs statement regarding attributing such differences to transaction costs is taking the issue too lightly. The statement is confusing. The IASB need to provide a better analysis on its view of bid-ask spreads.

Most advantageous market

We have concerns regarding the notion of most advantageous market. According to the ED;

- Paragraph 8, "A fair value measurement shall assume that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access."
- Paragraph 10, "An entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market. The market in which the entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market.
- Paragraph 11, "In the absence of evidence to the contrary, an entity may assume that the *principal market* for the asset or liability is the most advantageous market, provided that the entity can access the principal market. The principal market is the market with the greatest volume and level of activity for the asset or liability."

Reporting entities can operate in many markets buying or selling the same or similar goods, services or financial instruments. Some of these may not seem to be the most advantageous markets, but are the markets the business operates in, normally for a good reason. We believe that a fair value measurement should be based on a value that reflects cash flows that are likely to occur. Using values and assumptions from a market to which the entity has access, but not being the market in which the business intends to transact, will not provide relevant financial information. Our view is that the notion should be changed from "the most advantageous markets" to the "market in which the business transacts or would transact".

Another aspect of the most advantageous markets is the issue of businesses buying in one market to sell in another markets, an example is buying in a wholesale market and selling in a retail market. This should be resolved in a way that on re-measurement, does not lead to including the retail margin in the fair value measurement. E.g. a financial instruments acquired in a certain market should be re-measured using prices

from the same market, else there will be day one profits or losses, that will not reflect any actual changes in market prices. Instead those gains (normally) would to some extent represent future margins from reselling the acquired financial instrument on the retail market.

In paragraph 9 it is stated; "Because different entities (and businesses within those entities) with different activities enter into transactions in different markets, the most advantageous market for the same asset or liability might be different for different entities. Therefore, the most advantageous market (and thus, market participants) shall be considered from the perspective of the reporting entity." This description is confusing. Based on the logic presented in the previous section our view is that the market(-s) to use, should be the market(-s) the businesses of the reporting entity operates in, which could be more than one for the same or very similar goods, services or financial instruments.

We are also opposed to the notion of the most advantageous markets, because it will in many cases be very complicated to practically apply and the caveat given, "An entity need not undertake an exhaustive search..", will be used so extensively and interpreted in so many ways, that there will be a big draw back on consistent application . The notion of most advantageous market will in many cases just become something very theoretical and really not applied.

Highest and best use

The notion of highest and best use will in some situations not lead to financial information that support forecasting of cash flows. This may occur when assets are not intended to be used the way market participants would see as the highest and best use.

Measuring a current value based on a use that is not intended by the owner, will in many cases not fulfil the objective of forecasting. Our view is that the notion of highest and best use should be taken out when an asset is intended by the owner for a use that differs from the highest and best use.

When an asset is measured at an exit price and the intent is to sell rather than use, the market price will reflect the highest and best use based on what the market participants know.

Use of the exit price

Non financial assets

The exit price should only be used when it is relevant, based on an entity's business intent, e.g. with respect to IFRS 3, IAS 40 and IAS 41.

Non financial liabilities
Valuation should be based on the amounts that are expected to be settled.

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Financial assets
Only assets that are actively traded and assets for which exit price can be established based on observable market transaction information should be valued at the exit price.

Financial liabilities
Liabilities which are actively traded as part of a trading portfolio should be valued at the exit price. Those that are actively traded but are used to finance asset that are held to maturity should not be measured at an exit price. Neither should other financial liabilities.

Fair value accounting for liabilities

In the ED in paragraphs 27 and 28 is stated that 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 and if there is no corresponding asset for a liability an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. Although the technique is based, in part, on a settlement notion (i.e. cash flows incurred to fulfil the obligation), it produces the same price that would be paid to transfer a liability at the measurement date, provided that technique is applied in a manner consistent with Appendix C. We do not agree with this general way to describe exit values of liabilities. Measurement of liabilities can not be seen in isolation from how liabilities can be transferred or extinguished, because a reporting entity can in most cases not transfer or extinguish a liability at the price of a corresponding asset.

The non-performance risk is included in the fair value from the perspective of those that hold an entity's liability as an asset, as it is a risk that may impact the holder's return on the asset. The perspective of holders of those instruments and the perspective of those obligated to settle those instruments, are very different from one another. In considering an instrument only as a liability, the market participants that an entity might be able to transfer the liability to, would after transfer normally, be obligated to ultimately settle the liability at a later date in full. That is why fair value of an asset should in most circumstances not be used to measure the corresponding or a similar liability. In case there really is a need for a fair value definition for liabilities, that will be settled, rather than transferred, we believe there should be two definitions for fair value of liabilities.

We believe that fair value accounting for liabilities, recognizing gains and losses from changes in own credit risk, should be limited to specific situations and that those should be described in the standard, to minimize the risk of inappropriate use. It should be made clear that the definition of fair value when it concerns liabilities, only refers to special circumstances on initial recognition and to situations where the liability really can be extinguished through transferring the liability or buying the corresponding asset at the "price" being the fair value, if not two definitions are created as suggested above.

Recognizing gains on initial recognition

In paragraphs 34-37 fair value and initial recognition is discussed in a way that we see as too vague. It should be made clearer that transaction price between unrelated

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parties is to be seen as fair value, unless clearly proven not being a fair value. The way it now is written can open up to more of reporting of gains and losses on initial recognition. We believe that the IASB should revisit the rules that make it possible to report gains on initial recognition. In our view gains reported on initial recognition should be possible in very rare situations, based on undisputable proof, if at all permitted.

Measurement techniques

Appendix C includes guidance for expected present value techniques. This is also covered by IAS 36 in A1-A14. We think that the the guidance in IAS 36 A1-A14 should be replaced with a reference to the Appendix C of the proposed Fair Value Measurement standard. Our view is based on that the guidance in appendix C is clearer and eliminating duplication of guidance of techniques, will reduce the risk for misunderstanding. Some consequential changes may then also be needed in IAS 36 A15-A21.

We think that the proposed definition of Market-based value in IFRS 2 should be amended to reduce the risk of confusion. We propose that the definition should read as follows: "*Market-based value* is the price that would be received or paid to sell an asset, transfer a liability, or exchange an equity instrument, in an orderly transaction between market participants at the measurement date, not taking into account market participants' assumptions for vesting conditions <u>that are not market conditions</u> and reload features."

Disclosures

The ED proposes to add to IAS 34 Interim Financial Reporting all disclosure requirements for financial instruments included in the ED. Our view is that this should be revisited and the requirements reduced to focus on the really significant situations.

If the IASB still would retain the notion of highest and best we do not believe in the disclosure requirement set out in paragraph 60. It requires entities to disclose the fair value of the assets both in current use and highest and best use. The requirement would add additional cost to valuations and we doubt that the cost outweighs the benefits of such information. Having a disclosure requirement as such and at the same time not requiring exhaustive search for alternative uses, can lead to information that is misleading. The disclosure requirement can lead users to get the impression, that all material differences between current use and highest and best use are being disclosed.

Time to revisit the use of fair value in all IFRSs

As fair value has now been in use for some time, we believe that it is time for the IASB to revisit all standards with fair value accounting requirements, to study both the quality of fair value measurements and to what extent fair values as reported satisfies user needs, where active markets are not existent.

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Fair values or current values?

To create financial reporting that can fulfil the two key objectives of financial reporting, evaluation of performance and basis to forecast cash flows, historical cost based measures are not always enough. To fulfil these objectives, financial reporting sometimes needs to be able to capture current values. Many IFRSs include a measure with the label "fair value", with the aim to satisfy the need for a current value measurement. Another measure used in IFRS to satisfy the need of current value measurement is "value in use".

The tendency is that the label "fair value" is spreading to more IFRSs and new areas of application. Measurement requirements under the label "fair value" cover various kinds of assets, assets used in different ways, assets with "markets" that works in all kinds of ways and which to a large extent are nothing like active markets.

"Fair value" has and is being heavily criticised and we believe that it is time for the IASB to question if the fair value measurement, as described in the ED and as applied presently, has not been taken too far in IFRSs. We also believe its time for the IASB, to consider if the label "fair value" should be removed. "Fair" can easily lead to giving an impression of the measure being superior to all alternative measures, fulfilling all presentation requirements and at the same time being objective.

Our view is based on the following observations:

- At least Level 3 measures can hardly be seen as objective.
- "Fair value" does not take into account intent of use of a specific asset, which leads to that "fair value", in many cases is not a good basis for cash flow forecasting.
- Labels are important for understanding and communication.

It would indeed be great, if one type of measurement, reasonably tightly defined, could satisfy the need for current value measurement. Unfortunately measurement should portray so many situations, including a very broad range of facts and circumstances, and our view is that this should much clearer have to be acknowledged by IFRS. The use of the label "fair" and the broad definition as used and as proposed in the ED creates confusion.

Our view is that other measures, than those based on historical cost, should be referred to as "current values" or something equivalent and under such a label , there should be clearly labelled valuation concepts, as one current value measurement concept, reasonably tightly defined, will never solve the need for current values in all types of situations. We think that the label "Fair value" has created too much confusion and needs to be replaced.

For measurement using a current value, the valuation concept to use should be based on the intended use of the asset or liability and based on what information is available, which to a large extent depends on if there is useful market information available and what kind of market(-s) exists in a specific measurement situation. Current value measurement concepts could be;

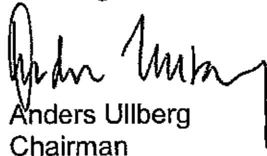
- Exit value - market based; Would in principle cover measurement situations described as Level 1 and 2 in the ED.
- Exit value - not market based; Would in principle cover measurement situations described as Level 3 in the ED, beside replacement cost.
- Value in use, entity specific cash flow estimates, discounted with current market interest rates.
- Replacement cost, to be used as a surrogate for an exit or a value in use measure in lack of reasonably reliable market exit or value in use information.

We thus support the creation of a separate standard that clarifies how to measure, but believe that IFRS should take a broader view on measurement as discussed above.

If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by e-mail to: carl-eric.bohlin@radetforfinansiellrapportering.se

Stockholm, September 28, 2009

Kind regards,



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