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Sir David Tweedie
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30 Cannon Street
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on Exposure Draft ED/2009/5 *Fair Value Measurement*. Principal authors of this comment letter were Peter Bitzyk, Julius Gaugusch, Ingrid Jakob, Erich Kandler, Michael Laminger, Ernst Schönhuber, Gerhard Schröder, Helmut Sorger and Roland Nessmann.

General Remarks

We agree with the IASB's objective, to provide a single definition for fair value appli-cable for all IFRSs, in order to improve consistency in application. But, as described in detail in our answer to the several questions below, we are not sure whether this goal is achievable with the measures of the proposed amendment.

The revised definition of fair value seems to be appropriate for financial instruments, but we do not see how fair value as now defined can usefully be applied in the rec-ognition and measurement of all financial instruments without taking into account an entity's intent and ability to transfer the financial instruments. Furthermore, we see problems with using this definition for non-financial instruments, e.g., leasing, and for some types of transactions, e.g., business combinations or construction contracts.

What is of crucial importance for the proper understanding of our answers below is that our comments on the ED are based on the assumption that this is a exhaustive definition of fair value, and that our comments should not – under any circumstances - be understood as implying approval for a broader use of fair value in the recognition of assets or liabilities in the statement of financial position or in the statement of comprehensive income.

As a general suggestion, we propose the inclusion of a link from the recommenda-tions of the FCAG to the present ED by explaining the rationale of the approach taken in the ED and the connection with the FCAG report.

Response to the questions in the ED

Question 1

The exposure draft proposes defining fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs.
Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

The question is what is meant by "fair value on its sale or in use": to the extent that what is being discussed is financial instruments, which can more or less easily be sold, it seems to be applicable in the majority of cases – at least for assets. We see a problem, however, in that an entity does not always have the will <u>and</u> the ability to sell certain of its assets, or to repurchase its liabilities. We consider that the definition of fair value must take into account also the ability of the entity to sell its assets or to repurchase its liabilities. This ability may be constrained by legal or regulatory provisions, by contractual arrangements or by the need to hold assets as funding for employee benefits.

In our view, this concept of fair value is dependent on two hypotheticals: the ability of the entity to sell its assets or repurchase its liabilities, and in some cases, on the hypothetical calculation of a value based on market parameters of other transactions and the intention of other market participants.

The existence of a single fair value

Additionally, we see other problems with the concept of a single fair value:

a) What is the unit of measurement for financial instruments? As we have seen in the present financial crisis, it may be possible to find a counterparty for a small packet of fungible financial instruments such as shares, but not for the whole of the position at risk. As pointed out in paragraph 49 et seq of the ED, multiplying the unit market price by the number of shares would not give a true and fair view of the fair value of positions at risk. In some circumstances, the same financial instrument needs to be treated in more than one way: if an entity holds an easily tradeable unit for trading, it should be measured by multiplying the market price in an active market by the number of shares; whereas additional shares, which the same entity holds for other reasons, should be measured in accordance with paragraph 49 et seq.

b) Most transactions take place because the expectations of the two parties concerning the fair value are different. The acquirer has higher expectations than the vendor, sometimes because of inten-ded future use within his entity. It does not seem logical that under these circum-stances a hypo-thetical future exit price should be the fair value for the acquirer.

c) The value of using an asset will generally be higher than the one achievable in an orderly sale. The right of use for an asset for a lessee may exceed the price achievable in an orderly sale. The same may be true for assets in construction contracts as described in IAS 11.The defini-tion of fair value in the proposed standard particularly needs further clarification or implemen-tation guidance as far as the “in use” and “in exchange” valuation rationales are concerned. In the typical industrial firm, the value in use of a component of an operating cash generating unit, for instance, is signifi-cantly different from the replacement cost (exchange value) and dif-ferent again to the proceeds obtainable on realisation (exit price). On the one hand, there are economies of scope depending on a complete set of components, i.e., in essence an operat-ing industrial plant, which cannot be attributed to single assets with the remainder being the fair value of intangible assets. On the other hand, the in use valuation of paragraph 23 is based on the assumption that other market partici-pants will have access to the same econo-mies of scope, e.g. entity-specific know-how, which is hypothetical and misleading if limitations to the use beyond transaction cost exist. Summing up, the replacement value of a component will generally neither coincide with the “value in use premi-se” nor with the “value in exchange premise”, i.e., the proceeds from the sale of that component, especially if the latter is a part of machinery built to customer specifications. Please also refer to our answers regarding most advantageous market / market participants below. In our opinion it should be emphasised that – particularly in the case of non-financial instruments – an exit price generally differs from the value in use.

d) In business transactions, assets, liabilities, and contingent liabilities are acquired for future use in the reporting unit. Using an exit price for the initial measurement of such assets, regardless of whether they are acquired for future use or for sale, seems unlikely to give a true and fair view of the reporting entity.

e) For equity interests measured at cost under the existing IAS 39 because their fair value is not reliably measurable, an additional question arises: if the fair value could not be measured re-liably in the past as jn an arm’s length transaction, it does not seem plausible that it can now be reliably measurable at an exit price. In our view, impairment tests are not the same as a fair value measurement.

Most advantageous market / Market participants

As stated in paragraph 9 et seqq, the most advantageous market need not be the same for vendor and acquirer: the vendor wishes to maximise net proceeds, while the acquirer wants to minimise acquisition costs, sometimes influenced by market access. This is contrary to the assumption in paragraph 27, that the observed price for a debt security held as an asset also represents the fair value of the issuer's liability.

<u>Conclusion:</u>

In the light of all this problems, we would prefer a value in use as a proper solution for all assets and liabilities, including financial instruments: the value should always be measured on the basis of the use in the entity.

Question 2

In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts:

a) *In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 Share-based Payment and reacquired rights in IFRS 3 Business Combinations) (see paragraph BC29 of the Basis for Conclusions).*
b) *The third context is the requirement in paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.*

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

a) We have chosen not to comment on this topic.
b) As far as paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement is concerned, we are of the opinion that this rule is more a rule for the recognition of these liabilities than a rule for the measurement of the fair value of these liabilities. As men-tioned in our general remarks, we do not see this ED as a draft for changing the recogni-tion rules of IFRS, but as a con-

solidation of various fair value definitions in several IFRSs. Measurement of liabilities with a demand feature should thus not be dealt with in this ED. The measurement issue regulated in IAS 39.49 should be taken into account by proposed new hedge accounting rules in the upcoming ED promised for 2010. If this rule, however, is seen as a fair value measurement rule, it would implement the idea of value in use for financial instruments in the ED, which from our point of view would be a preferable solu-tion.

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions).
Is this approach appropriate? Why or why not?

We see a number of practical issues, especially with tangible assets. Depending on the physical location of an asset, prices may vary, with differently advantageous markets with different prices. The most advantageous market must not necessarily be the one where the asset was acquired. The fair value of an asset would therefore include day one arbitrage gains. Take for instance an industrial site acquired for intended use in industrial operations, which could alternatively be developed for residential use at a premium. Property development and sale for residential use might then be the most advantageous market, although the property was still used industrially and the entity had no intention to develop the site for residential use. Does the mere possibility of alternative use constitute a different valuation rationale? We must then be aware that the determination of fair values is driven by the definition of hypothetical markets and hypothetical market access. This could conflict with the purpose of financial statements as explained in IAS 1.7, where it states that the statement " ... along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty". A fair value based on a non-intended use of an asset may lead to wrong expectations about future cash flows and thus be misleading. What management has to take into account, however, is its responsibility to make the best use of the funds with which it has been entrusted.

Question 4

The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions).
Is the description of market participants adequately described in the context of the definition? Why or

why not?

As explained in our answer to Q1, we see problems in measuring fair value by “using the assumptions that market participants would use in pricing the asset or the liability”. For example, when markets are not very liquid, the measurement of blocks of shares may result in a wide variety of possible outcomes, depending on the assumptions about future interest rates or cash flows used in the model. Thus, from our point of view, an entity can only be obliged to use its own expectations consistently in its financial statements and to disclose them.

Question 5

The exposure draft proposes that:

a) the fair value of an asset should consider a market participant’s ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).

b) the highest and best use of an asset establishes the valuation premise, which may be either ‘in use’ or ‘in exchange’ (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).

c) the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

1. For (a), please refer to our answer to Q 1, first paragraph. From our point of view legal con-straints on selling an asset or repurchasing a liability must be taken into account in measure-ment, in order to avoid misleading information for users of the statements.
2. As far as the highest and best use for non-financial assets is concerned, we see a heavy bur-den for the proper preparation of financial statements if this search is not to be limited to the use of assets for the reporting company’s intended purpose. The regular monitoring of differ-ent markets for physical assets for which fair values are reported requires additional efforts in the preparation of financial statements that might not be offset by additional decision useful in-formation being gained. We believe that, in order to avoid misleading expectations, the “high-est or best use” must be an intended use of the asset consistent with the reporting entity’s strategy.
3. For liabilities, please refer to our answer to Q1.

Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions).
Is the proposed guidance sufficient and appropriate? If not, why?

1. With respect to the fair value, please refer to our answer to Q 5.
2. “Highest or best use” should be limited to an intended use consistent with the reporting entity’s strategy. The example in paragraph 20 could be misleading, as the demolition of the factory could cause the reporting group heavy losses if its output was crucial for to the success of the group as a whole. It has to be asked at which level – strategic, operational at group level, op-erational at single entity level or at cash generating unit level - the test for a “highest or best use” is to be car-ried out, because the values could presumably differ.
3. As already mentioned in our general remarks, we do not see this ED as an expansion of fair value measurement for recognition purposes in financial statements. Thus we see para-graph 21 as an aberration. We strongly oppose any expansion of the use of fair values in the recognition of assets or liabilities in financial statements without previous discussion.

Question 7

The exposure draft proposes that:

a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).
b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer’s liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).
c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to as-sume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling

the obligation, adjusted for any differences between those cash flows and the cash flows that o-ther market participants would incur (see paragraph 28 of the draft IFRS).

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

1. As explained above, from our point of view the inability of the reporting entity to repur-chase a liability because of legal or supervisory restrictions must be taken into account; the same rules as in IAS 39.49 – implementing the value in use – may be practical for all financial instruments.
2. Especially in recent times, the bid-ask spread in still active markets may be very large, so that the use of this price range may lead to different values for the holder of an asset and the issuer of the liability. The most advantageous market for buyer and seller need not to be the same, also leading to differences. There may be different prices for the same classes of assets – e.g., a small trading position and a large interest.
3. Please refer to our answer to Q4.

Question 8

The exposure draft proposes that:

a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfil the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).

b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

1. We want to make clear once again that this is true only for the measurement of the fair value, not for the recognition of own liabilities in the issuing entities' financial statements.
2. As previously explained, we believe this not to be correct: where, e.g., the fair value of an asset – which may be tradeable – can be different to the fair value of the same financial instrument as a li-ability in the issuing reporting entity's financial statements, when the re-purchase is subject to le-gal or supervisory restrictions.

Question 9

The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39,

on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions).
Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

As explained in our general remarks, in our view the ED should only replace existing and some-times different definitions of fair value with a single new one. It should not deal with recognition is-sues, e.g., recognition of day one profits. Recognition issues and the effects of these issues on the statement of comprehensive income should be discussed and clarified in other projects.

Question 10

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples).
Is this proposed guidance appropriate and sufficient? Why or why not?

In principle we agree.

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions).
Are these proposals appropriate? Why or why not?

We consider these requirements to be in line with the existing disclosure requirements for financial instruments in IFRS 7, so we see them as appropriate for financial instruments. To the extent that non-financial assets and liabilities have to be taken into account, we fear that the requested infor-mation is not only a heavy burden for the reporting entity as well as for its auditors but leads to an increasing flood of information which would impact both clarity and the decision usefulness of general financial reports. These additional disclosure requirements should be limited to material items, otherwise the true and fair view would be endangered.

Question 12

The exposure draft differs from Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157.
Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

We have chosen not to comment.

Question 13

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

As explained in our general remarks and in our answers to several questions, we consider that this ED should only be used to improve the clarity of the fair value definition and should not ex-pand the application of fair value in the recognition of assets and liabilities in financial statements.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman