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By e-mail [CommentLetters@iasb.org](mailto:CommentLetters@iasb.org) and by post

8 May 2007

Mr. Jon Nelson  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Mr. Nelson,

**IASB Discussion Paper: *Fair Value Measurements***

The Hong Kong Institute of CPAs is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Discussion Paper.

We support the IASB's initiative in establishing a clear definition of fair value and developing a single set of guidance that will apply to all fair value measurements required by IFRSs with a view to codify, clarify and simplify existing guidance that is dispersed widely in IFRSs. We understand that this is an important project as it forms part of the convergence program between IFRSs and US GAAP.

Our responses to the questions set out in the Invitation to Comment are set out in the appendix for your consideration. The response is provided on the understanding that the Discussion Paper seeks to establish a framework for *how* fair value is measured if another IFRS requires fair value to be measured and that the Discussion Paper does not address the question of *when* fair value should be adopted as the appropriate measurement attribute for any given asset or liability. Therefore, our comments on this Discussion Paper should not be taken as an indication of our support for any further extension of the use of fair value within IFRSs.

We consider that the question of *when* to adopt fair value as the most appropriate measurement attribute is an important debate which requires further consultation of preparers, users and auditors. We encourage the Board to consider whether existing requirements for the use of "fair value" (however described) would be appropriately met by replacing fair value with current exit price, or whether some other measurement basis would be more appropriated. The Board's preliminary views could be conveyed through proposed consequential amendments to other standards in the Exposure Draft which will result from this Discussion Paper.

If you have any questions on our comments, please do not hesitate to contact me at [patricia@hki CPA.org.hk](mailto:patricia@hki CPA.org.hk).

Yours sincerely,

Patricia McBride  
Executive Director

PM/EC/al

**Hong Kong Institute of CPAs****Comments on the IASB Discussion Paper  
*Fair Value Measurements*****Issue 1 – SFAS 157 and fair value measurement guidance in current IFRSs.**

**Q 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?**

We believe that having a single source of guidance for each measurement basis used in IFRSs will be beneficial to preparers, auditors, users of financial statements and regulators. It will help to eliminate the need for constituents to consider guidance dispersed throughout IFRSs, which has been developed piecemeal over time and may have inconsistencies that have added to the complexity in IFRSs. We believe that this project provides an opportunity for establishing the principles and conceptual guidance for addressing measurement issues.

While a single source of guidance for a particular measurement base does not necessarily reduce complexity, it will improve consistency of application.

Although the proposals in the Discussion Paper are generally appropriate to financial instruments, as is the purpose of SFAS 157 *Fair Value Measurements*, IFRSs uses fair measurement in a wider context. IFRSs also define fair value more broadly than US GAAP. As a result, the exit price concept may not necessarily be the appropriate “fair value” to apply in the full range of IFRSs which currently incorporate fair value measurement. We therefore urge the Board to undertake a comprehensive review of existing IFRSs which currently incorporate fair value measurements to determine whether an exit price is indeed the relevant measurement basis to meet the measurement objective of each individual standard.

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

In general, SFAS 157 provides sound guidance on current exit price measurement. It should be noted that current IFRSs require more extensive application of fair value than current US GAAP and therefore exit price measurement guidance may not necessarily be applicable in all cases where fair value measurement is presently required in IFRSs.

## **Issue 2 – Differences between the definitions of fair value in SFAS 157 and in IFRSs**

### **Issue 2A – Exit price measurement objective**

**Q 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?**

We are not convinced that exit price should be the basis for computing all the fair values as are currently required or allowed to be computed under existing IFRSs. We suggest that further research should be conducted in this respect to test each IFRSs separately to see whether exit price is the appropriate measurement attribute.

The definition of an exit price is established on the basis that the objective of a fair value measurement is to determine the price that would be received for the asset or paid to transfer the liability at the measurement date. This is because it embodies current expectations about the future inflows associated with the asset and the future outflows associated with the liability from the perspective of market participants. This is not necessarily an appropriate measurement basis, in particular, for liabilities for which there is no developed secondary market where settlement may be a less costly option than transfer.

The exit price concept is inconsistent with certain current guidance in IFRSs. For example, IAS 39 states that the appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price (see IAS 39 AG 72). We therefore encourage the Board to consider reviewing on a standard-by-standard basis to determine whether the exit price concept is appropriate for situations where fair value measurement is currently required.

**Q 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.**

We believe that an entry price in an arms' length transaction also reflects current market-based expectations of flows of economic benefit into or out of the entity for assets that are held for sale and for liabilities that are to be transferred. However, many assets held by entity are for use in the business operations and their value in use would be a better reflection of the expected flows of economic benefit into or out of the entity subsequent to initial recognition of the assets. Similarly, liabilities are usually assumed with a view to being settled in the future and therefore we believe that the settlement value is relevant in many situations.

Entry and exit prices are likely to differ when, for example, they are occurred in different market, there is different counterparty credit risk, the market is inefficient, the price is an entity specific price, etc.

**Q 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.**

Yes, it would. The term of “fair value” is generic and is broadly interpreted within financial reporting. To avoid confusion, we support replacing the term “fair value” with more precise terminology for ease of understanding the measurement basis in each individual IFRSs. This will also enable the Board to fine tune the selection of current values applied in different situations.

**Q 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 IFRSs 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.**

We believe that the Discussion Paper has correctly pointed out that fair value measurement on initial recognition required by IFRS 3, IAS 17 for the initial recognition of assets and liabilities by a lessee under a finance lease and IAS 39 for the initial recognition of some financial assets and financial liabilities is inconsistent with an exit price measurement objective, and in practice, entry price is applied.

#### **Issue 2B – Market participant view**

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

We generally agree. However, we are not sure whether the assumption that the buyers or sellers are “independent” of the reporting entity means that they are completely independent and have no relationship in any form such as customer loyalty. In reality, business counterparts do build up some form of relationship over time. The fact that a customer has a normal business relationship with the reporting entity may render the transaction price being different from that of a transaction with an unknown third party while at the same time the transaction remains an arm’s length transaction.

**Q 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?**

We generally agree that the market participant view in SFAS 157 is broadly consistent with the concepts of “knowledgeable, willing parties in an arm’s length transaction” as defined in IFRSs. However, we consider that the concepts in IFRSs are broader and more relevant to Level 3 of the hierarchy while it is not clear how the market participants’ view can be used in Level 3 where there is no market.

### **Issue 2C – Transfer versus settlement of a liability**

**Q 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?**

Certain financial liabilities, such as derivative liabilities and certain highly liquid non-derivative financial liabilities, may be assumed by entities with the intention to transfer. However, we believe that, in the majority of cases, liabilities are assumed with the intention to settling rather than transferring the liabilities. Transfer of liabilities in those cases is purely hypothetical and simply does not happen. We doubt whether estimating the value of a liability on a transfer basis can be considered as a pervasive principle for measuring the fair value of a liability.

**Q 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?**

Yes, they are different. Fair value basis is not widely used in IFRSs for measuring liabilities except for certain financial liabilities where guidance is contained in IAS 39. Liabilities are conventionally measured on a settlement basis. For financial liabilities which have no active market, IAS 39 requires the use of a valuation technique such as cash flow analysis which measures the amount to settle the liabilities (rather than an amount paid to transfer the liabilities).

### **Issue 3 – Transaction price and fair value at initial recognition**

**Q 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.**

We consider that, in the absence of a fair value measurement based solely on observable market inputs, the transaction price is the most appropriate measure of the value of an asset or a liability at initial recognition. We do not agree that model-based estimate of fair value at initial recognition based on inputs that are not observable in a market would provide more relevant information and a better understanding of the economics of the transactions as compared to the transaction price.

**Q 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.**

It is unclear whether 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. The unit of account guidance in IFRSs is unclear other than for financial instruments quoted in active markets where it means the individual instrument and is inconsistent between IFRSs. We believe that the Board should articulate its concerns in this area by addressing it as part of the review of the conceptual framework and then considering its application in individual IFRSs.

#### **Issue 4 – Principal (or most advantageous) market**

**Q 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?**

We agree that a fair value measurement should be based on the principal market for the asset or liability because generally the principal market for an asset or liability will represent the most advantageous market for the asset or liability. However, in the absence of a principal market, it should be based on the market where the transaction occurred. In the absence of a principal market, the choice of the most advantageous market can be arbitrary depending on the extent of search undertaken. Requiring entities to continuously search across all possible markets in which transactions for the asset or liability can be observed for the most advantageous price would not be cost effective and impose excessive burden on the entity. The ease of access will also affect whether the most advantageous market as defined in SFAS 157 is in fact the most “advantageous” to market participants. In addition, we consider that more comprehensive guidance on the concept of principal market at Levels 2 and 3 of the hierarchy would be necessary.

#### **Issue 5 – Attributes specific to the asset or liability**

**Q 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?**

We 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 where there is a liquid market.

**Q 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?**

In theory, we 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 rather than the asset/liability. However, an entity normally takes into account the amount of transaction costs when deciding whether a transaction should be undertaken. We consider that individual standards should consider whether transaction costs should be capitalised or expensed as, for example, is presently the case in IAS 39, where transaction costs are expensed for those instruments at fair value through profit or loss and capitalised for all others.

#### **Issue 6 – Valuation of liabilities**

**Q 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?**

Yes, we agree that credit risk should be considered in measuring the exit price of a liability. This is consistent with the current guidance in paragraph AG 69 of IAS 39 which states that fair value reflects the credit quality of the instrument.

#### **Issue 7 – ‘In-use valuation premise’ versus ‘value in use’**

**Q 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?**

Yes, it is clear that the two concepts are different. The “in-use valuation premise” used in SFAS 157 is determined on the basis of the highest and best use of the asset by market participants, even if the intended use of the asset by the reporting entity is different. In contrast, “value in use” in IAS 36 incorporates an estimate of future cash flows that the entity expects to derive from the asset and does not require those cash flows to be adjusted to reflect market participant expectations. However, we are concerned that preparers and users may be confused by the similarity in the terminology and therefore recommend the use of the familiar term “highest and best use” instead.

#### **Issue 8 – Fair value hierarchy**

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

We agree that Level 1 inputs are the most preferred choice. Conceptually Level 2 sounds more preferable than Level 3 inputs. However, we are not sure whether all Level 2 inputs are superior to Level 3 inputs. For example, we believe that outdated quoted prices for similar assets in markets are no better than an estimation using current unobservable inputs that reflect the entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability.

Furthermore, we consider that the hierarchy should also consider the valuation technique used, and not only the inputs to that technique. That is, if an entity chooses to use a valuation model which is not widely used in the market (e.g. one that it has constructed itself), this should also cause the resulting valuation to be relegated to a lower level in the hierarchy, irrespective of whether the entity feeds observable inputs into that model.

**Q 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?**

Yes, the differences between the levels of the hierarchy are clear in principle but are likely to be less clear in practice. We recommend the development of more guidance on the application of the hierarchy, in particular on the application of Levels 2 and 3.

#### **Issue 9 – Large positions of a single financial instrument (blocks)**

**Q 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.**

Theoretically, a blockage adjustment should be prohibited for Level 1 and this should apply as a principle to all levels of the hierarchy since the market participants' perspective assumes willing market participants. However, quoted prices usually reflect normal trading volumes and liquidity does come into play when a market participant prices a transaction. Such an adjustment is relevant for determining the exit price. We doubt whether in practice willing market participants always exist for Levels 2 and 3 and therefore the blockage adjustment may become relevant. If the quoted price is adjusted, the adjustment renders the fair value measurement a lower level measurement.

#### **Issue 10– Measuring the fair value within the bid-ask spread**

**Q 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.**

Since most market transactions take place at a price within the bid-ask spread, we support the guidance in SFAS 157 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. We recognise that exercise of judgement is required in determining what constitutes "most representative of fair value in the circumstances" and therefore recommend that further guidance should be added.



**Q 22: 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?**

We consider that an exception should only be allowed when it does not result in a materially different value to a price within the bid-ask spread and that the approach has to be applied consistently.

**Q 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?**

We consider that the principle of measuring fair value using the price that is most representative of fair value in the circumstances should be applied to all levels of the hierarchy. The application of the bid-ask pricing guidance is fairly straightforward for instruments that fall within Level 1 of the hierarchy. However, this may not necessarily be the case for Levels 2 and 3 and therefore further pricing guidance for these two levels is necessary.

#### **Issue 11 – Disclosures**

**Q 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.**

Disclosure can be extensive and complicated for Level 3 and potentially for Level 2. We encourage the Board to make due consideration for cost effectiveness and understandability of financial information.

#### **Issue 12 – Application guidance**

**Q 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.**

More guidance on the application of Levels 2 and 3 would be needed to ensure that the standard's principles are appropriately and consistently applied since the proposed standard is written using a rather theoretical approach and may not be easy to apply to specific situations. We do appreciate that it would not be possible to develop guidance that is comprehensive enough to cover all situations.

**Q 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).**

Please see answer to Q25.

**Issue 13 – Other matters**

**Q 27: Please provide comments on any other matters raised by the discussion paper.**

We suggest that the IASB should take into account the existing valuation standards and guidelines issued by bodies such as the International Valuation Standards Committee in developing its fair measurement standard to ensure that either they are consistent or major inconsistencies are adequately considered.

**- END -**