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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Email: commentletters@iasb.org

28 September, 2009

Dear Sir David,

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

Deloitte Touche Tohmatsu is pleased to respond to the International Accounting Standards Board's (the "IASB" or "Board") Exposure Draft ED/2009/5 *Fair Value Measurement* (referred to as the "ED" or "draft IFRS").

We support the Board's efforts to replace the existing guidance on fair value measurement in IFRS accounting literature with a single standard and strive for closer convergence with fair value measurement requirements in Accounting Standards Codification Topic 820 (ASC 820), *Fair Value Measurements and Disclosures,* (formerly Statement 157), issued by the U.S. Financial Accounting Standards Board (FASB). Global convergence is important as it serves to further reduce complexity and application issues that often result from inconsistent principles in similar U.S. and international standards. Moreover, convergence of this draft IFRS will result in more consistent measurement of fair value among IFRS preparers and better comparability with entities preparing financial statements under U.S. GAAP. Furthermore, we understand that full convergence to ASC 820 may not be appropriate in instances where the IASB ED has demonstrated a more conceptually superior principle. However, in areas where the IASB does agree with the principles in ASC 820, we recommend the verbiage be closely aligned as not to create wording differences that cause confusion among constituents.

Similar to ASC 820, the ED has defined 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." We believe this exit price notion is the most conceptually sound approach for fair value measurement. However, we also believe that fair value is not an appropriate measurement attribute for some types of liabilities, as discussed in our comment letter on the IASB's Discussion Paper DP/2009/2, *Credit Risk in Liability Measurement,* which is attached as Appendix B. In addition, because most liabilities cannot be transferred, the most practical measure of a current value of liabilities may be settlement value. However, since the amount at which a liability may be currently settled could be affected by the holder's commercial practices, costs, and other considerations, it is appropriate to look to other evidence to estimate fair value such as what the FASB describes in Accounting Standards Update 2009-05 (ASU 2009-5), *Measuring Liabilities at Fair Value,* issued in August 2009. ASU 2009-5 provides guidance on how to estimate the fair value of a liability in a hypothetical transfer transaction and was issued in response to requests from constituents for additional guidance on how to measure fair value of liabilities. The Board should consider this standard issued by the FASB with the common goal of convergence in mind.

Some proposals within the ED do not move the draft IFRS towards convergence and, we believe, have not been demonstrated to be conceptually superior to ASC 820. For example, such proposals include, but are not limited to, the most advantageous market concept, the definition of a "knowledgeable" market participant, and the accounting (deferral) of certain day one gains and losses.

We have concerns regarding why, from a conceptual viewpoint, the entity should be presumed to normally transact in the most advantageous market rather than the principal market. As a result of this approach, if an entity were to conclude there was a market that was more advantageous than the market it principally transacts in, it would measure items at a higher fair value, only to recognize losses when it transacts in its principal market. We believe the IASB should revise its approach to look to the principal market first and only if there is no principal market, look to the most advantageous market.

We have conceptual and practical concerns about the way in which "knowledgeable" is described in the proposed definition of a market participant. The ED indicates that the market participant would be presumed to be as knowledgeable as the reporting entity about the asset or liability. This implies that the market participant has access to entity-specific information that is not publicly available. This turns the definition of a "market participant" into an entity-specific concept. We believe the definition would benefit from closer alignment to the ASC 820 definition. While the principles are somewhat similar, the difference in wording may yield interpretations by IFRS preparers that could produce outcomes that are unintended and differ from an exit price notion of fair value.

We also have concerns about the ED's proposed amendments to IAS 39 for the deferral of day one gains and losses in instances where the initial transaction price does not equal fair value for a transaction in which unobservable inputs are utilized in a valuation model. We believe that in such circumstances a deferral should not be recorded, but the valuation model generally should be calibrated (either through the inputs or through valuation adjustments) such that model value equals the transaction price at initial recognition.

We encourage the IASB to reconsider its guidance in IAS 39 for initially recognizing transactions at fair value that are not subsequently measured at fair value. For items that are not subsequently measured at fair value, we believe the transaction price generally is more relevant than an exit price for initial recognition (although, in most instances there should be little or no difference). When an item is not subsequently measured at fair value, the most relevant initial value is the amount of resources incurred or received upon entering into the arrangement (presuming the transaction was on an arm's length basis).

We recommend the Board consider incorporating concepts from Part I of the IASB Expert Advisory Panel paper "Measuring and disclosing the fair value of financial instruments in markets that are no longer active" issued in October 2008 as application guidance within the draft IFRS. We believe the incorporation of the best practices identified in the document would be useful for users determining fair value measurements in inactive markets. Furthermore, the FASB recently issued a proposed Accounting Standards Update, *Improving Disclosures About Fair Value Measurements,* intended to improve disclosures related to fair value measurements and increase transparency in financial reporting. We encourage the Board to work with the FASB on this disclosure project.

We understand that the IASB will hold three round tables to discuss its proposals in the ED in the coming months. We would like to participate in each of the round tables in the United States, Japan and the United Kingdom.

Our detailed responses to the invitation to comment questions are included in Appendix A to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

Appendix A: Invitation to Comment

Definition of fair value and related guidance
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?

Yes, this definition is appropriate. The IASB should proceed with its definition of fair value as stated above. ASC 820 also establishes an "exit price" objective for fair value measurements. The use of the exit price provides an appropriate objective for fair value measurement that can be applied consistently. One consistent definition between ASC 820 and the draft IFRS would further serve to reduce the complexity and application issues that could result if two different definitions of fair value were to exist. We further believe that the exit price notion is the most conceptually sound approach for fair value measurement.

However (as discussed in our cover letter and noted in our response to Question 9), we would encourage the IASB to reconsider its guidance for initially recognizing transactions at fair value that are **not subsequently measured at fair value**. For items that are not subsequently measured at fair value, we believe the transaction price generally is more relevant than an exit price for initial recognition (although, usually there should be little or no difference). When an item is not subsequently measured at fair value, the most relevant initial value is the amount of resources incurred or received upon entering into the arrangement (presuming the transaction was on an arm's length basis).

Scope
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?

Yes, we believe the proposed approach to the three contexts identified by the Board is appropriate.

In addition, we believe that the term 'fair value' used in IAS 20, paragraph 23; IAS 39, paragraph 43; and IAS 41, paragraphs 12 and 13 do not reflect the Board's intended measurement objective. We recommend the Board exclude each of these paragraphs from the scope of the draft IFRS for the following reasons:

- For IAS 20 paragraph 23, we believe the Board should exclude this paragraph from the scope of the draft IFRS as these types of government assets are not subject to sale. For example, in the case of a defense industry entity which has obtained plant and equipment or technical know-how from the state, the fair value measurement of the asset would not be appropriate since the sale of the assets is not possible and a reference market does not exist.

- For IAS 39, paragraph 43, we believe the Board should exclude this paragraph from the scope of the draft IFRS. We understand the "fair value" at initial recognition in paragraph 43 to be geared toward a

buying market instead of a sales market. Therefore, we do not agree with an exit price notion in this entry situation.

- For IAS 41 paragraphs 12 and 13, we believe the Board should also exclude these paragraphs from the scope of the draft IFRS as these assets are not subject to sales. The exit price notion is not appropriate at the initial recognition of biological assets (e.g., a potato crop at the moment of sowing) which are used to grow agricultural produce. This is because the agricultural produce (e.g., harvested potatoes) is subject to a sale but not the biological asset (e.g., the potato crop).

We would also encourage the Board to provide the results of the case study involving the valuation of the identifiable assets acquired and liabilities assumed in the sample business combination discussed in paragraph BC20.

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?

No. Paragraphs 10-11 of the ED indicate (in part) that 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." Further, it goes on to say that absent evidence to the contrary, "**the principal market** for the asset or liability **is the most advantageous market**."

We are not convinced that the proposed approach represents a significant improvement to the approach in ASC 820. Looking to the principal market is more practical than searching for potential alternative markets that may be more advantageous. For example, identifying the most advantageous market for commodities that are transacted in multiple markets around the world may require complex and subjective judgments about transaction costs and transportation costs and the potential for arbitrage if the item being measured were transported to various markets around the world. Additionally, if an entity were to conclude there was a market that was more advantageous than the market it principally transacts in, it would measure items at a higher fair value, only to recognize losses when it transacts in its principal market. We believe the IASB should revise its approach to look to the principal market first and only if there is no principal market, look to the most advantageous market. We believe a deviation from the principal market concept in ASC 820 may cause confusion amongst constituents and application issues.

If the Board chooses not to change the approach, we recommend that in addition to the commentary provided at paragraphs BC39-BC40, the IASB should further address why it is reasonable to assume that the market in which an entity normally transacts should typically be considered the most advantageous and why the most advantageous approach is superior.

We also believe that the level of market activity may be a factor that should be considered in determining the "most advantageous market".

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?

No. The ED defines market participants as independent of each other, knowledgeable about the asset or liability and willing and able to enter into a transaction for the asset or liability. We have conceptual and practical concerns about the way in which "knowledgeable" is described in the proposed definition of a market participant.

“Knowledgeable” is specifically defined in paragraph 13(b) of the ED as someone “sufficiently informed to make an investment decision and [...] **presumed to be as knowledgeable as the reporting entity** about the asset or liability.” Further paragraph BC45 in the basis for conclusion of the ED indicates, “**The market participant and the reporting entity are presumed to be equally knowledgeable about the asset or liability**, although neither party is perfectly knowledgeable. In other words, **a fair value measurement does not reflect information asymmetry,** although it does reflect information uncertainty (i.e. the uncertainty an entity faces because it does not have perfect knowledge about the timing and amount of future cash flows).”

This definition is problematic because it implies that the market participant has access to entity-specific information that is not publicly available. To illustrate, assume the reporting entity has access to “insider” information about the item being measured. In that case, the proposed definition of “knowledgeable” assumes that the market participant has access to the same “insider” information even though that information is not available in the market which does not seem realistic. Under this definition of a market participant, therefore, there may be a difference between observable market prices and “fair value” solely because those market prices do not capture “insider” information. This turns the definition of a “market participant” into an entity-specific concept.

In our view, the threshold for a “knowledgeable” market participant in ASC 820 represents a more conceptually sound basis for this concept. ASC 820 defines knowledgeable as “having a **reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary**.” Further paragraph C34 in the basis of conclusions of Statement 157 indicates, “… some respondents questioned the extent to which market participants would be expected to be knowledgeable, referring to markets that are characterized by information asymmetry, where some market participants have information about an asset or liability that is not available to other market participants. The Board agreed that it would be reasonable to presume that a market participant that is both able and willing to transact for the asset or liability would **undertake efforts necessary to become sufficiently knowledgeable about the asset or liability based on available information, including information obtained through usual and customary due diligence efforts**, and would factor any related risk into the fair value measurement. In our view, there is always a level of information asymmetry. We believe that the appropriate reference point for “knowledgeable” in paragraph 13(b) of the ED should be akin to what a market participant might be able to ascertain from due diligence efforts. This represents the realities of the marketplace and how deals are transacted. We also believe the “due diligence” threshold is far more understandable and operational.

We propose the IASB provide guidance that a transaction price associated with a related party transaction, which was consummated at arm’s length and was evidenced by other market quotes, may be representative of fair value.

Application to assets: highest and best use and valuation premise
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?

We have the following concerns associated with the proposals in items (a) – (c):

- We encourage the IASB to provide additional examples that more realistically represent the complex nature of evaluating highest and best use. The current examples in the ED are overly simplistic.

- While the requirement to assess highest and best use is consistent with ASC 820, we recommend that the IASB obtain input from the FASB and practitioners as to operational issues which may have been encountered by constituents in implementing this requirement. Since ASC 820-10-55-23A (formerly FSP FAS 157-2) delayed the effective date of ASC 820 for nonfinancial assets until 2008 (for most entities), there has not been a significant amount of time to observe the nature of practice issues which may exist. Based on its research, the IASB should assess the need to provide more application guidance in its ED. We also recommend the IASB provide clear guidance to indicate that an entity need not undertake an exhaustive process or go to unreasonable lengths to determine all the potential uses of the asset and which use would be the absolute highest and best.

- We believe it is rare that the highest and best use of a commodity is something other than its actual current use in its current form. For example, should an entity with crude oil look to all of the different potential uses of that oil (e.g., refined oil, gasoline, electricity through oil burning plants) and only add conversion costs to derive different potential fair values when there is a market for crude oil? We recommend the elimination of the requirement to measure the fair value of a commodity assuming its highest and best use by market participants. This revision would be consistent with the reasoning for exclusion of financial assets from the highest and best use requirement.

- We also are concerned about the theory that in the highest and best use analysis, an entity can look to the fair value of the item in another form and only back out the costs of conversion in determining the fair value of the item in its current state. It would seem logical that if an entity were to purchase the asset and convert it, the entity would likely back out an expected profit margin as well. Similar to our point above about crude oil, power/electricity generating entities do not operate as non-profit enterprises. They expect to make money by converting the oil into electricity. As such, they would not pay a price for oil that would look to power prices and burn rates and only back out the costs to convert. They would add in an expected profit margin.

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?

The guidance is not clear as to how the incremental value would be assigned in situations where more than one depreciable asset is involved. In the land and factory example provided in paragraphs 20 and 21, the incremental value is assigned to the land, and therefore, the incremental value would not be depreciated. Constituents would benefit from an example that would illustrate how the incremental value would be assigned when multiple depreciable assets are valued based upon the hypothetical highest and best use of each asset. In addition, we recommend the IASB clarify how the concept of components might apply to the proposals in paragraphs 20 and 21. For example, would the excess fair value have to be allocated to the various components of a building? The interplay with IAS 16 requirements should be clearly contemplated and addressed.

Application to liabilities: general principles
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 assume 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 other 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?

(a) Yes, consistent with ASC 820, the proposal that a fair value measurement assumes that the liability is transferred to a market participant at the measurement date is appropriate only in certain circumstances. However, the Board should be mindful that under ASC 820, the requirement that fair value of liabilities be measured under the assumption that the liability is transferred to a market participant (i.e., the liability to the counterparty is not settled, but continues) triggered the need for additional FASB guidance on how to estimate the fair value of a liability in a hypothetical transaction that assumes the transfer of a liability to a third party. In practice, few liabilities are transferred to another party, although some liabilities are settled directly by the issuer with the counterparty and some are traded as assets. Therefore, the FASB recently issued ASU 2009-5 in response to requests from constituents for additional guidance. We recommend the IASB update the draft IFRS to reflect this additional guidance issued by the FASB on measuring fair value of liabilities.

Additionally, we believe that fair value is not an appropriate measurement attribute for some types of liabilities as discussed in our comment letter on the IASB's DP/09/2, *Credit Risk in Liability Measurement*. Our comment letter is attached as Appendix B.

(b) For paragraph 27, we recommend the IASB consider the guidance in ASU 2009-5 and clarify that in the absence of a quoted price for the identical liability, when traded as an asset in an active market, the entity may measure fair value based on a valuation technique that uses a quoted price of a similar liability or of a similar liability when traded as an asset. In addition, an entity may also use other valuation techniques based on the amount an entity would pay to transfer the identical liability or based on the amount an entity would receive to enter into an identical liability (i.e., an entry price).

(c) We believe that the proposals in paragraph 28 related to liabilities for which there is no corresponding asset (e.g., decommissioning liabilities) would be difficult to implement and require a great deal of judgment to apply. We would encourage the IASB to provide more implementation guidance on how to determine the required inputs. Below are some examples of guidance to consider providing:

- If there is not an active market in which entities assume the liabilities of other entities, how would an entity go about getting the information required to estimate the price that a market participant would demand to assume its liability?
- What would be the risk profile of the market participant?
- How should the risk premium a market participant demands be determined?
- What are the appropriate sources of information given the infrequency of sales of liabilities?

Application to liabilities: non-performance risk and restrictions
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?

(a) For paragraphs 29-30, while we do not support a fair value measurement for some types of liabilities, we agree conceptually that non-performance risk should be reflected in fair value measurements of liabilities as discussed in our comment letter on the IASB's DP/09/2, *Credit Risk in Liability Measurement*, which is attached as Appendix B. In our comment letter we outline four different measurement attributes for liabilities. We believe the board should consider our proposed set of principles governing when the measurement of a liability should incorporate credit risk.

(b) The ED should clarify and discuss the principles governing whether or not a separate adjustment should be made for contractual restrictions in the fair value measurement of a liability, both at inception and at subsequent measurement. The lack of a thoroughly explained reasoned principle could cause practice issues; accordingly, we recommend that the IASB establish a clear principle to guide the determination of whether an adjustment should be made.

    Paragraph 31 of the ED indicates that "**a restriction on an entity's ability to transfer a liability** to another party **does not affect the fair value of the liability**." The phrase "does not affect" in this sentence seems to indicate that the fair value measurement of a liability would never include the effect of a restriction. We recommend the IASB clarify the wording in this sentence to state that the fair value estimate of a liability would not be adjusted for contractual restrictions **if** the impact of such a restriction is either implicitly or explicitly included in the other inputs to the fair value measurement. For example, the impact of the restriction would typically have already been factored into the transaction price for the liability at inception, since both the issuer and the creditor have accepted the terms of the transaction (e.g., debt issuance). Therefore, an adjustment for the restriction again, for fair value measurement purposes, would result in double counting. In unusual circumstances, however, an obligor may have a contractual or statutory right to transfer a liability to one or more specified parties without the holder's consent. For instance, an obligor may sometimes have a contractual right to transfer its obligation to a defeasance trust that is set up on pre-specified terms. In such a case, the right to transfer the liability would have been considered in the transaction price and the entity would need to consider the impact of this transfer right when determining the fair value of a similar liability that does not contain the right-to-transfer clause.

    In addition, we believe that the IASB should address the impact of restrictions prominently not only for liabilities, but also for assets.

Fair value at initial recognition
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?

We agree with the guidance in paragraph 36 of the ED that the transaction price is the best evidence of fair value at initial recognition unless the factors in paragraph 36(a)-(d) apply. This guidance is consistent with ASC 820-10-30-3. However, we disagree with amendments made in paragraph D32 to IAS 39 paragraph AG 76(b) that a gain or loss should be deferred if the criteria in IAS 39 AG76(a) are not met. Instead, consistent with ASC 820-10-30-4, we believe that for transactions in which unobservable inputs are utilized in a valuation model, the valuation model generally should be calibrated (either through the inputs or through valuation adjustments) such that model value equals the transaction price at initial recognition.

For paragraph 36(d) of the ED, the example of a securities dealer should be expanded to include other wholesale market participants. For instance, in commodities markets, different entities may operate as

wholesale commodity trading organizations, which operate in a different market than an end-user, retail market participant.

We also recommend that the IASB reconsiders its guidance in IAS 39 for initially recognizing transactions at fair value that are **not subsequently measured at fair value**. For items that are not subsequently measured at fair value, we believe the transaction price generally is more relevant than an exit price for initial recognition. When an item is not subsequently measured at fair value, the most relevant initial value is the amount of resources incurred or received upon entering into the arrangement (presuming the transaction was on an arm's length basis).

Valuation techniques
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?

We note that the guidance starting in paragraph B5 relates to determining fair value in markets that are not active. However, the guidance in ASC 820-10-65-4 (formerly FSP FAS 157-4) relates to determining fair value when there has been a significant decline in market activity (which may or may not be indicative of an inactive market). Although the factors listed in ASC 820-10-35-51A may relate to determining when a market is not active, we believe that as currently incorporated in the ED not all the factors listed are in themselves indicative of an inactive market (see next bullet). We recommend the IASB conform the wording in the ED to ASC 820, except as noted below or specifically list factors characteristic of a market that is inactive to avoid any confusion and misapplication.

- The characteristic listed in paragraph B5(a) (i.e., a significant decrease in market activity) is not indicative of an inactive market but of a market that is less active, but which may still be active.

- The IASB should clarify in paragraph B5(c) what is meant by "current information." Is it based on actual trades or just the availability of quotes, which may not be based on any actual transactions?

- The characteristic in paragraph B5(d) implies that the market for a security may be deemed inactive just because price quotations vary substantially over time; however, the security may be traded in significant volume on a daily basis. That is, significant price volatility is not necessarily an indicator that a market is inactive. Although many equity securities issued by large financial institutions experienced significant declines in price in 2008, they continued to be traded in significant volumes on a daily basis.

- The characteristic in paragraph B5(e) suggests that the market for a security is inactive if indices that were previously highly correlated are demonstrably uncorrelated with recent fair values. However, this is not necessarily indicative of an inactive market. For example, a publicly traded stock that was previously correlated to an index (e.g., S&P 500) may no longer be correlated but may still be traded in significant volume.

- The characteristic listed in paragraph B5(h) (i.e., a significant decline or absence of a market for new issues) is not indicative of an inactive market if there is an active secondary market or the market is less active, but still active.

- We recommend the IASB consider adding "immediately" prior to "to meet regulatory or legal requirements" criteria in paragraph B11(c) to avoid any misapplication. Even though an entity is required to sell, it may still have adequate time to allow for customary and usual marketing activities.

- We recommend the IASB further clarify the criteria in paragraph B11(d). What if significant events occurred related to the specific asset which caused the transaction price to be an outlier? Would the IASB still consider the last transaction not to be representative of fair value?

We recommend that the IASB consider incorporating concepts from Part I of the IASB Expert Advisory Panel paper "Measuring and disclosing the fair value of financial instruments in markets that are no longer active" (October 2008) as application guidance within the draft IFRS for measuring fair value in inactive markets.

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?

Fair value measurement disclosures are the subject of a current FASB proposed Accounting Standards Update, "*Improving Disclosures About Fair Value Measurements*." The IASB should coordinate its fair value disclosure requirements with those of the FASB.

The ED proposes that an entity disclose certain items in paragraphs 56-61 which are not required by ASC 820. We generally agree with the additional disclosures required by the ED which appear to provide relevant, useful information to users of the financial statements. However, we would encourage the IASB to perform field testing with preparers and to reach out to various constituency groups, including users, to determine the usefulness of these additional disclosures. The IASB should consider modifying paragraph BC110 of the ED to address these differences and other disclosure differences noted below. The additional items identified that are not currently required by ASC 820 are as follows:

1. "Significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers." [paragraph 57(c)]
2. For Level 3 fair value measurements, changes in one or more of the inputs to "reasonably possible alternative assumptions" that significantly affect fair value, and the effects of those changes. [paragraph 57(g)]
3. Fair value, by level within the fair value hierarchy, "for each class of assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed. "[paragraph 58]
4. Certain disclosures "for each class of liability measured at fair value after initial recognition." [paragraph 59]
5. Certain disclosures when "an asset is used together with other assets and its highest and best use differs from its current use." [paragraph 60]

ASC 820's disclosure requirements apply to both financial and nonfinancial assets in both interim and annual reports. Instead, the ED proposes amending IAS 34, *Interim Reporting,* to require disclosures about the fair value of financial instruments in interim financial statements. Currently, no interim fair value measurement disclosures would be required for nonfinancial assets and liabilities. We believe the ED should also amend IAS 34 to include interim disclosures of nonfinancial assets and liabilities that are subject to fair value measurements.

Under ASC 820, an entity is required to provide different disclosures for recurring fair value measurements than it does for nonrecurring fair value measurements. The ED does not distinguish between recurring and nonrecurring fair value measurement disclosures. The IASB should consider the disclosure requirements in ASC 820 that explicitly require separate disclosure of assets and liabilities that are measured at fair value on a nonrecurring basis in periods subsequent to initial recognition.

Paragraph 57(b) states, in part, “the level in the fair value hierarchy into which the fair value measurements are categorised in their entirety.” Although there is nothing incorrect with the proposed sentence, we recommend the IASB conforms the wording to ASC 820-10-50-2 to clarify that fair value measurements must be categorised in their entirety in one of the three levels of the fair value hierarchy (i.e., a single fair value measurement cannot be broken down into different levels based on the levels of the inputs used). Suggested revisions to the proposed sentence are noted below (changes are indicated in strikethrough or underline):

> “the level within ~~of~~ the fair value hierarchy in ~~within~~ which the fair value measurements ~~are categorised~~ in their entirety fall, segregating fair value measurements using any of the following: (1) quoted prices in active markets for identical assets or liabilities (Level 1), (2) significant other observable inputs (Level 2), and (3) significant unobservable inputs (Level 3).”

Paragraph 57(c) requires entities to provide a reconciliation of Level 3 balances and the total amount of unrealised gains or losses (proposed paragraph 27B(c)) for the period included in profit or loss for those assets and liabilities still held at the end of the reporting period. These disclosure requirements are consistent with ASC 820, which has been applied in the U.S. since 2007 (for early adopters). Such disclosures have resulted in implementation issues and diversity in application in the U.S. which potentially diminishes the comparability and usefulness of these disclosures. Application issues identified in the U.S. include, for example, (a) when are transfers assumed to occur between categories (for example, is the transfer from Level 2 to Level 3 (or vice versa) assumed to occur at the beginning of period, end of period, mid-month, or on a specific date), (b) how to compute unrealised gains and losses included in profit or loss and settlements for contracts subject to periodic net settlements (e.g., swaps), and (c) whether the amounts to disclose under the Level 3 reconciliation should be disclosed for both interim-to-date and year-to-date periods, in interim financial statements. We suggest the IASB provide application guidance on the Level 3 reconciliation disclosures to help ensure consistency in application and usefulness of such disclosures. This comment is consistent with our response dated 15 December 2008 on the Exposure Draft, *Improving Disclosures about Financial Instruments* –Proposed amendments to IFRS 7.

Paragraph 61 of the ED indicates that quantitative disclosures required by the standard shall be presented in “tabular format unless another format is more appropriate.” We believe the alternative to use another format is an improvement over ASC 820 which requires that fair value disclosures be presented in a tabular format only.

Convergence with US GAAP
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?

In our view, there is merit in the IASB and the FASB working together to conform the principles of their respective standards. Divergence in the principles between the IASB standard on fair value measurement and ASC 820 will increase complexity and application issues, reduce comparability of financial statements across jurisdictions, and/or lead to other unintended consequences.

Throughout our response, we have identified areas where we believe the approach in ASC 820 is superior to the ED. The main areas are as follows:

- The principal versus most advantageous market concept (see our response to Question 3 above)
- The definition of a market participant (see our response to Question 4 above)
- The accounting for fair value at initial recognition (see our response to Question 9 above)

Other differences that are not identified in the ED include:

- ASC 820 recently was revised to provide additional guidance about the measurement of liabilities at fair value (see our response to question 7 above and ASU 2009-5).
- Under ASC 820, an entity is required to provide different disclosures for recurring fair value measurements than it does for nonrecurring fair value measurements. The ED does not distinguish between recurring and nonrecurring fair value measurement disclosures. (see our response to Question 11 above)
- Unlike ASC 820, the ED does not propose interim disclosures for nonfinancial assets and liabilities. (see our response to Question 11 above)
- The ED requires certain disclosures that are not currently required by ASC 820, including:
  - "Significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers."
  - For Level 3 fair value measurements, changes in one or more of the inputs to "reasonably possible alternative assumptions" that significantly affect fair value, and the effects of those changes.
  - Fair value, by level within the fair value hierarchy, "for each class of assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed."
  - Certain disclosures "for each class of liability measured at fair value after initial recognition."
  - Certain disclosures when "an asset is used together with other assets and its highest and best use differs from its current use."

As we noted in our response to Question 11 above, we would encourage the IASB to perform field testing with preparers and to reach out to various constituency groups, including users, to determine the usefulness of these additional disclosures.

Other comments
Question 13
Do you have any other comments on the proposals in the exposure draft?

Yes, we have the following additional comments:

- While we agree with the definition and core principle in paragraph 1 (as further explained in paragraph 15), further consideration should be given to other areas where there is no observable exit price, for example, providing a practical expedient for using net asset value (NAV) similar to the FASB's proposed FSP FAS 157-g.

- Paragraphs B3 and B4 of the ED provide examples of Level 2 and 3 inputs for particular assets and liabilities. We believe more commodities-specific examples would be helpful for constituents. For instance, a forward physical contract to purchase a particular grade of crude oil (where grade differentials may cause a contract to be either level 2 or 3), or a contract to purchase natural gas or power at a particular location (where delivery location may cause a contract to be either level 2 or 3).

- Paragraph 24 of the ED indicates that "The fair value of a financial asset determined using the in-exchange valuation premise reflects any benefits that market participants would derive from holding that asset in a diversified portfolio. As a result, the in-use valuation premise is not relevant for financial assets." We are concerned that the ED does not address whether the unit of valuation can be different from the unit of account. We recommend that additional guidance be provided to clearly distinguish between the unit of account and the unit of valuation. To illustrate, if an entity holds a portfolio of derivative contracts that are subject to a single master netting agreement, the impact of the master netting agreement on the valuation of individual derivatives must first be determined at the portfolio level before it can be allocated to individual derivative contracts. In this case, the unit of valuation for the impact of the master netting agreement differs from the unit of account. In this case, it would be impractical, if not impossible, to determine the impact of credit risk on the fair value of each derivative contract on a stand-alone basis, since the master netting agreement only applies at the portfolio level.

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1 September 2009

Dear Sir David,

Re: Discussion Paper, *Credit Risk in Liability Measurement*

Deloitte Touche Tohmatsu is pleased to respond to the Discussion Paper, *Credit Risk in Liability Measurement* (the "Discussion Paper"). We support the Board's effort to address this critical topic and believe that future standard setting would benefit if the IASB were to define a consistent set of principles for when credit risk should be reflected in liability measurements.

To assist in the development of such a set of principles, the Board should first define the various potential measurement attributes that could be applied to liabilities as part of Phase C of its Conceptual Measurement project. Below we outline the measurement attributes that we believe the Board should consider. Subsequently, we discuss our proposed set of principles governing when the measurement of a liability should incorporate credit risk.

Measurement Attributes

At this time, we support further consideration of four different measurement attributes for liabilities.

1. *Fair value* – Standard-setters define 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, i.e., an exit price.[1] Because fair value, as proposed to be defined by the IASB, is a price in a current market transaction, this measurement attribute reflects the impact of the entity's own credit risk.

[1] The IASB's May 2009 Exposure Draft, *Fair Value Measurement*, and FASB's Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures* (formerly FASB Statement No. 157, *Fair Value Measurements*).

2. *Amortised cost.* – For a liability, amortised cost is "the amount at which the ... liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount."[2] Typically, this measurement attribute reflects the entity's own credit risk at initial recognition. For example, when a financial liability is measured at the amount of cash proceeds received, the amount of cash proceeds generally reflects the entity's credit risk. However, subsequent changes in credit risk are not reflected in subsequent measurements.

3. *Current Measurement Using a Frozen Credit Spread* – This measurement attribute uses a present value technique that discounts the expected future cash flows at a current benchmark rate (such as a risk free rate, an interbank benchmark rate, or a bank prime rate) plus (or, in some circumstances, minus) the spread that applied to the liability at initial recognition. Subsequent measurements reflect changes in the benchmark rate; but changes in credit risk are ignored. Similar to amortised cost, this measurement attribute reflects the entity's own credit risk at initial recognition, but subsequent changes in credit risk are not reflected in subsequent measurements.

4. *Current Measurement Using a High Quality Credit Approach* – This measurement attribute uses a present value technique that discounts the expected future cash flows using a current high quality discount rate, for example, the current risk free rate or the current discount rate for high quality corporate bonds. This measurement attribute excludes the effect of the specific credit risk of the issuer both at initial recognition and in subsequent measurements.

Proposed Set of Principles for Choosing a Measurement Attribute

Initial Measurement:
Liabilities arising from exchange transactions in which the obligations are customarily issued or priced at inception on terms that consider the credit risk of the liability should be measured initially at an amount that incorporates the credit risk of the liability. For instance, if an entity borrows cash, the cash proceeds and the interest terms of the liability typically will reflect the credit risk of the liability at initial recognition. Similarly, if an entity receives a non-cash asset (such as a car) in exchange for a promise to pay over a period of time, the terms of the transaction typically will reflect the credit risk of the liability. We strongly believe that the act of borrowing at the prevailing interest rate applicable to the borrower is not an event that gives rise to an immediate gain or loss or an event that results in a reduction in the entity's equity capital.

Additionally, where an entity enters into a derivative liability, while the terms may not include an explicit adjustment for credit risk (e.g., where two swap counterparties have similar credit risk), credit risk would typically be reflected in the terms (e.g., through collateral arrangements or, if credit risk is significant, compensation in the pricing terms). Credit risk should be reflected in the initial measurement of such liabilities.

For liabilities that are incurred in which the counterparty (if identified) does not customarily negotiate terms that consider the credit risk of the liability, we propose that credit risk should not be reflected in the initial measurement (nor subsequent measurement) of the liability. For instance, liabilities that relate to contingent obligations (e.g., litigation), post-employment benefit obligations and decommissioning liabilities are often incurred without terms or conditions from third parties reflecting the specific credit risk of the liability. For such liabilities, the timing and amount of payment are an estimate and without defined terms. These estimates generally do not include credit risk of the entity. We propose that such

[2] Paragraph 9 of IAS 39, *Financial Instruments: Recognition and Measurement.*

liabilities be measured both initially and subsequently using a high quality credit spread approach as described above.

Subsequent Measurement:
For those liabilities in which the initial measurement incorporates the specific credit risk of the obligation, the subsequent measurement could be fair value, amortised cost, or a current measurement using a frozen credit spread. We believe the Board should establish principles for determining which measurement attribute is most appropriate to the subsequent measurement of a liability based on the characteristics of the liability.

Note that credit risk may not be the only or the primary basis for choosing a subsequent measurement attribute. For example, fair value measurement should continue to be required for derivative liabilities, not only because the measurement incorporates a current credit risk component but because fair value is the most relevant measure for an instrument (a) that may have little or no initial investment and (b) whose value potential changes in significant magnitudes in response to a specified variable(s) (such as an interest rate, commodity price, or equity price index) that is not specific to one of the parties to the contract.

In determining the best subsequent measurement attribute, the board should consider the relevance of changes in the issuers own credit to investors. For example, for most debt obligations, the issuer does not have the practical ability to realise gains associated with decreases in their credit worthiness. They are also not required to absorb losses associated with increases in their credit worthiness in debt obligations. Thus, changes in an issuer's own credit is generally not relevant and should not be incorporated in the subsequent measurement of most debt obligations. This would lead to debt obligations being measured at amortised cost or a current measurement using a frozen credit spread (whether fixed rate debt obligations should be measured using a frozen or current benchmark interest rate is not a topic for this Discussion Paper). Where the issuer could realise changes in value of a liability due to changes in its own credit risk, a measurement attribute incorporating current risk (e.g., fair value) may be appropriate.

Other Issues
In developing a new consistent set of principles, the Board will also need to address certain issues:

Selection of a Discount Rate – For certain obligations, such as, post-employment benefit obligations, decommissioning liabilities, and provisions, where credit risk is not priced into the terms, we propose that the expected cash flows be discounted using a high quality discount rate. The Board would need to clarify how such a discount rate should be selected.

Business Combinations – If the obligation is measured by the acquiree using a technique that excludes the impact of own credit, will the Board provide a scope exception from the measurement requirements of IFRS 3, *Business Combinations*? If not, how would an acquirer account for a "gain" resulting from fair valuing the obligation at the acquisition date (if such an obligation was measured using a higher quality discount rate by the acquiree)? Would the "gain" be included in the calculation of goodwill?

Reclassification – If an entity's assessment of its practical ability to realise gains and losses from credit risk changes, should the measurement attribute change, for example, from a high quality credit approach or frozen credit approach to fair value (or vice versa)?

Derivatives – Although we continue to support fair value for derivatives, in developing a consistent set of principles for credit risk in liability measurement, the Board may wish to consider whether the current measurement of obligations inherent in derivative financial instruments should include own credit risk. We recognise that the terms of non-derivatives

and derivatives are inherently different, however, with respect to own credit risk many derivatives are similar to non-derivatives, for example, they are over-the-counter arrangements where the obligor has limited ability to transfer or settle the obligation outside of its contractual terms at an amount that includes change in the fair value of the obligor's credit risk.

We encourage the Board to coordinate its efforts and any standard setting projects the Board may undertake as a result of this Discussion Paper, with the FASB to help achieve the common goal of convergence between IFRSs and U.S. GAAP.

Our detailed responses to the questions for respondents are included in Appendix A to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

Appendix A: Questions for Respondents

Question 1

When a liability is first recognised, should its measurement (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why?

(a) If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?

(b) If the answer is 'never':
- ***i. What interest rate should be used in the measurement?***
- ***ii. What should be done with the difference between the computed amount and cash proceeds (if any)?***

Response 1

Sometimes.

As discussed in the body of this letter, if the customary third party negotiated terms and conditions of a particular type of liability reflects the credit risk of the arrangement (e.g., bank borrowings and issued debt securities), we believe the liability should initially be measured at an amount that reflects the issuer's credit risk (e.g., the amount of cash proceeds or other consideration received).

If the customary terms and conditions of a particular type of liability do not consider the credit risk associated with the liability (e.g., decommissioning liabilities and contingent obligations for litigation), credit risk should not be reflected in the measurement of the liability. Instead such a liability should be measured using a high quality credit approach.

Question 2

Should current measurements following initial recognition (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should subsequent current measurements exclude the price of the credit risk inherent in the liability?

Response 2

Sometimes.

As discussed in the body of this letter, we continue to support fair value measurement of derivatives. Credit risk may also be reflected in the subsequent measurement of a liability if the entity has the practical ability to realise gains or losses associated with changes in credit risk in the ordinary course of business.

Changes in credit risk should not be reflected in the subsequent measurement of non-derivative liabilities whose contractual cash flows are fixed or fluctuate solely based on a market interest rate (including non-leveraged inflation) and are not managed on a fair value basis. Similarly, changes in credit risk should not be reflected in the subsequent measurement of non-derivative liabilities where the entity does not have the **practical** ability to **realise**

gains or losses associated with changes in own credit in the ordinary course of business (i.e., other than in bankruptcy, liquidation or default) [emphasis added]. If such a liability has variable cash flows (e.g., payment terms based on earnings), a frozen spread approach is applied.

Moreover, credit risk should not be reflected in the initial or subsequent measurement of liabilities that are incurred on terms or conditions that do not consider the credit risk associated with the liability. Instead such a liability should be measured using a high quality credit approach.

Question 3

How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

Response 3

The separation of credit risk from other changes in value will often be arbitrary and rely on practical conventions. However, one approach that can be used and is being currently applied in practice in determining the change attributable to the credit risk inherent in the liability is outlined in paragraph IG11 of IFRS 7. This approach freezes the credit spread at the beginning of each period.

Further, another approach, a variant of the approach in paragraph IG 11 of IFRS 7, would be to freeze the credit spread at initial recognition rather than at the beginning of each reporting period.

Entities may also use information derived from data about credit default swap spreads, when available as another alternative.

Regardless of the approach used, we believe that the Board should clarify whether credit risk includes or excludes sector spreads (i.e., is the price of credit risk determined based on the issuer's credit spread relative to the overall market benchmark rate or to the prevailing rate for a particular sector?).

Question 4

The paper describes three categories of approaches to liability measurement and credit standing. Which of the approaches do you prefer, and why? Are there other alternatives that have not been identified?

Response 4

We do not support the "borrowing penalty" or the "shareholder put" approach as described in paragraphs 62(a) and 62(b), respectively, of the Discussion Paper. However, we encourage the Board to further explore the "frozen spread" approach as described in paragraph 62(c) of the Discussion Paper in certain circumstances. Discussed below are our reasons for our position noted above.

Borrowing penalty approach – As discussed in the body of our letter and in our response to questions 1 and 2 above, we believe that if a liability is issued for cash consideration, the

liability typically should be measured initially at the amount of consideration received. The act of borrowing at the prevailing interest rate is not an event that gives rise to an immediate gain or loss, which would be recognised under the borrowing penalty approach.

Shareholder put approach - We believe that the act of borrowing at the prevailing interest rate is not an event that results in a reduction in the entity's equity capital (e.g., as an imputed distribution of equity to the entity's owners). Instead a liability issued in exchange for cash consideration typically should be measured initially at the amount of consideration received. Further, even if the Board were to conclude that the amount attributed to the "shareholder put" should be initially recognised in equity, it would be inappropriate to amortise the amount to expense, because contracts properly classified in equity do not affect net income.

Frozen spread approach - We support further consideration of the "frozen spread" approach as an alternative to amortised cost or fair value for non-derivative liabilities with variable cash flows for which the terms and conditions initially reflect credit risk, but the issuer does not have the practical ability to realise gains or losses from changes in its own credit risk. We note, however, that this approach can result in complex "layering issues" for liabilities that arise over a period of time, since different components of the liability would be measured using different credit spreads. Additionally, as discussed in the body of this letter, we support further consideration of a "high quality credit approach" for liabilities that have terms and conditions that do not consider the credit risk associated with the liability.