Re: ED – Fair Value Measurement

Dear Sir or Madam,

MAZARS welcomes the opportunity to comment on the IASB Exposure Draft: *Fair Value Measurement*. Our answers to the exposure draft questions are shown in the appendix to this letter which summarises our concerns and opinion.

We welcome the Board’s proposal to issue a new standard on Fair Value Measurement in order to have a harmonised definition of what is “Fair Value” in the IFRS Framework. However we consider that grouping all “specific” application guidance in one standard is not the best way to proceed. We consider that it would be more efficient to let each specific standard (IAS 39, IAS 40 etc) dealing with its specific fair value measurement application guidance.

As a general comment, we believe that the proposed measurement method is very theoretical and is difficult to implement in practice for the reasons detailed below.

We understand that the purpose of the proposed standard is to deal with the “how to” measure fair value and not the “when to” measure at fair value which remains within the other existing standards. Even if we understand the rationale of this approach, we consider that it is very difficult to comment on the “how to” measure at fair value without dealing with the “when to” as we are convinced that this has a backward effect on the fair value definition (i.e. on the “how to”).

As already mentioned in our comment letter to the Discussion Paper *Fair Value Measurement*, we consider that the proposed fair value definition as the current exit price is not appropriate in all situations in which assets and liabilities are potentially subject to fair value measurement. Consider a loan originated by a bank, initially recognised at fair value and, in accordance with the bank business model to collect the loan’s contractual cash flows, subsequently measured at amortised cost. In this case we think that the initial measurement should be a primary market entry price rather than a secondary market exit price as the bank business model does not result in selling the loan on the secondary market. This example also outlines that an entry price can be different from an exit price each time that it refers to different markets which is the case for originated loans.
Moreover, as already underlined in our comment letter on the Exposure Draft Financial instruments: Classification and Measurement we are convinced that an efficient measurement approach should take into account the entity’s business model. For instance, we consider that an identified “most advantageous market” should be in line with the entity’s business model in order to result in a measurement consistent with its economic behaviour. We are convinced that a measurement approach relying on the entity’s business model is the best way to provide, from a user’s point of view, relevant information on the entity’s expected cash flows. We would like to stress that having a fair value measurement definition in line with the entity’s business model will not result in an entity specific measurement as the fair value would remain compatible with a market participant view.

Besides, we also disagree with the Board’s proposal to adopt a hypothetical transaction in the absence of actual transactions. We consider that when there is no observable data, a measurement on the basis of entity-specific data is the most reliable and the most appropriate way to predict the entity’s future cash flows.

Eventually, we strongly disagree with the exposure draft proposal that a liability’s fair value measurement assumes that the liability is transferred at the measurement date. We believe that a liability is generally settled, extinguished or cancelled but seldom transferred. Moreover, we strongly disagree with the exposure draft proposal to determine the fair value of a liability from the counterparty point of view for which it would be an asset as this approach would result in taking the entity’s non performance risk in the fair value measurement of the liability. As already mentioned in our comment letter to the Discussion Paper Credit Risk in Liability Measurement, we recommend that the Board excludes changes in non performance risk from any subsequent fair value re-measurement, except when the business model of the entity is to settle a liability at fair value.

Our detailed answers are set out in the Appendix.

Do not hesitate to contact us should you wish to discuss our comments.

Best regards,

Michel Barbet-Massin
Head of Financial Reporting Technical Support
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?

We understand that the purpose of the proposed standard is to deal with the “how to” measure fair value and not the “when to” measure at fair value which remains within the other existing standards. Even if we understand the rationale of this approach, we consider that it is very difficult to comment on the “how to” measure at fair value without dealing with the “when to” as we are convinced that this has a backward effect on the fair value definition (i.e. on the “how to”).

Indeed, as already underlined in our comment letter on the Exposure Draft Financial instruments: Classification and Measurement we are convinced that an efficient measurement approach should take into account the entity’s business model. For instance, we consider that an identified “most advantageous market” should be in line with the entity’s business model in order to result in a measurement consistent with its economic behaviour. We are convinced that a measurement approach relying on the entity’s business model is the best way to provide relevant information on the entity’s expected cash flows. We would like to stress that having a fair value measurement definition in line with the entity’s business model will not result in an entity specific measurement as the fair value would remain compatible with a market participant view.

We have concerns on the Board’s assumption which states that a current entry price is equal to a current exit price. We would like to underline that in some situations, entry price is different from exit price. For example, it is the case when the “entry” and “exit” markets from the perspective of the reporting entity are not the same. We think the price should refer to a market in line with the entity’s business model. We would also like to draw the Board’s attention that this issue may be more sensitive under IFRS than under US Gaap as fair value is more frequently used at initial recognition under IFRS.

We especially recommend adopting entry price when the instrument is measured at fair value only at initial recognition such as originated loans. For example, when a bank originates loans, initially measured at fair value and subsequently measured at amortised cost, we consider that the initial measurement should be made at the primary market entry price rather than the secondary market exit price retained by the exposure draft. Therefore, defining fair value as the current exit price is not appropriate for all situations in which assets or liabilities are subject to fair value measurement. That is the reason why we especially recommend adopting entry price when the instrument, consistently with the entity’s business model, is measured at fair value only at initial recognition and subsequently measured at amortised cost.
**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?

We agree with these scope exception.

**The Transaction**

**Question 3**

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?

We consider that the fair value measurement of an asset or a liability should be based on observable prices on the market for the asset or the liability used in accordance with the entity’s business model.

We think that the business model should be the driving principle to determine the reference market for valuation. It is necessary to identify this market among those in which the entity, or more precisely the subsidiary of the entity carrying the asset or the liability, operates.

We believe it is important that the reference market is the one chosen by the entity for its purchase or sale transactions on the relevant assets or liabilities and not a reference market or a hypothetical market on which it does not operate.
We think that the “principal market”, as a proxy to the most advantageous market, is not relevant even if the entity can access it. The “principal market” concept should be in line with the entity’s business model in order to take into account all restrictions faced by the entity such as the possibility for the entity to access to the market and the feasibility of the transaction on such market given the physical or legal restrictions. For example, an entity may have a theoretical access to a gas market but be unable to deliver or receive the gas traded on this market because it has neither the relevant facilities (pipelines access…) nor quotas.

Besides, we also disagree with the Board’s proposal to adopt a hypothetical transaction in the absence of actual transactions. We consider that, when there is no observable data, a measurement on the basis of entity-specific data is the most reliable and the most appropriate way to predict the entity’s future cash flows.

**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

The market participant view provided in the exposure draft as we understand it, is consistent with the idea of “knowledgeable, willing parties in an arm’s length transaction” within IFRSs.

We understand the market participant view in the context of a liquid market. When a market exists, we believe that it is relevant to give priority to market parameters rather than to “entity specific” parameters. However if there are very few market participants it will *de facto* result in a kind of entity specific approach.

In the absence of market, and in the case of in use valuation, we do not understand why the view of this hypothetical market participant would be more relevant than that of the entity. As the current holder of the asset or the liability, we consider the entity is having the best view on the fair value of this asset or liability.

Even if it relies more on a “when to” measure at fair value than on a “how to” measure at fair value, we would like to stress that we consider fair value measurement as irrelevant each time that the fair value cannot be reliably determined. This is consistent with our position expressed in our comment letter to the *Exposure Draft Classification and Measurement* regarding the fair value exemption for equity instruments for which fair value cannot be reliably measured.
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?

As already mentioned in our answer to question 1, we remain convinced that an efficient measurement model should take into account the entity’s business model. We would therefore favour an approach in which the choice between the in use and the in exchange valuation premise relies primarily on the entity’s business model. This way, the assumptions retained for the fair value measurement would be less numerous, as they would not refer to the hypothetical use that a hypothetical market participant would make of the concerned asset or liability.

We consider that, in some specific situations in use premise should be allowed for financial instruments. For example, a bank has debt liabilities and receivables towards one counterparty with a netting agreement. An in exchange premise (thus not taking into account the outcome of the netting agreement) would lead to measure both instruments individually leading to a flawed information of the bank’s credit risk exposure. We are convinced that, in this case, an in use premise would result in a better representation of the bank’s economic exposure.

We also strongly disagree with the “highest and best use” approach for liabilities as we consider that they are usually settled, extinguished or cancelled but rarely transferred (please also refer to our answers to questions 7 and 8).

Besides, we believe that the exposure draft clearly defines the difference between “value in use” and the “in-use valuation premise” but we encourage the Board to change the wording in order to avoid any misunderstanding with IAS 36.
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 (i.e. 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?

If the entity’s valuation approach is in line with its business model (refer to our answer to questions 1, 4 and 5), then this requirement is no more relevant.

APPLICATION TO LIABILITIES: GENERAL PRINCIPLES AND NON-PERFORMANCE RISK AND RESTRICTIONS

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?

As mentioned in our answer to question 1, an approach taking into account the entity’s business model would result in a liability’s measurement consistent with the manner the issuer extinguishes the liability.

As already mentioned in our answer to question 5, we believe that a liability is generally settled, extinguished or cancelled but rarely transferred.
Therefore, we strongly disagree with the exposure draft proposal to determine the fair value of a liability from the counterparty point of view for which it would be an asset. We are convinced that the business model of a debt instrument holder is rarely similar to the business model of the instrument’s issuer. Therefore, inferring the fair value measurement of a liability from the holder perspective would result in irrelevant information. Moreover, adopting the holder’s point of view would result in taking the entity’s non-performance risk in the fair value measurement of the liability. As already mentioned in our comment letter to the Discussion Paper Credit Risk in Liability Measurement, we recommend the Board to include the own credit risk component in initial measurement only when the own credit risk is priced into the transaction giving rise to the initial recognition of the liability (e.g. financial liability), and to exclude changes in own credit risk component from any subsequent re-measurement, except when the business model of the entity is to settle a liability at fair value.

Question 8

The exposure draft proposes that:

1. the fair value of a liability reflects non-performance risk, i.e., 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).

2. 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?

Please refer to our answer to question 7.

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 support the exposure draft’s proposal on the treatment of day one profits and the proposed changes compared to the discussion paper.
Nevertheless, we disagree with the removal of AG 74 to AG 75 and an extract of AG 76 leading to the removal of the definition of the valuation techniques used if the market is not active. We consider that it is important to keep in the proposed guidance the standardised model reference existing in AG 74 of the current standard IAS 39 which states that a valuation technique should be “commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of price obtained in actual market transactions”. To our mind a valuation technique should “incorporate all factors market participants would consider in setting a price” and should be “consistent with accepted economic methodologies for pricing financial instruments”. For example, a valuation technique using prices from observable current market transactions but excluding some risk factors in its methodology should not be applicable.

**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?

*Fair value hierarchy*

We are in favour of the hierarchy proposed by the exposure draft, but a decision flow chart would be necessary to understand all its implications.

We suggest the following presentation for clarification of the impact of the input data level:
We consider that the Board should also develop a more comprehensive decision tree taking into account the valuation premise (in use vs. in exchange) and the use of a valuation model. For example, this would help clarifying whether a valuation based on a standardised model with only level 1 input data would result in a level 1 fair value.

Interpolation vs. extrapolation

Paragraph B3 d) of the exposure draft deals with a level 2 input which could include the implied volatility for shares derived through extrapolation. We disagree with this application guidance. According to us, extrapolation technique should not be authorised as opposed to interpolation techniques which proves to be more reliable.

Moreover, we think that interpolation technique would result in a level 2 valuation only if the market is liquid and provides sufficient information to perform the interpolation reliably. Otherwise, we believe this technique leads to a Level 3 valuation.

Bid Ask Spread

We agree that it could exist a price which best represents the fair value of the relevant instrument within the bid-ask spread. However, this price can be difficult to assess, particularly for non banking companies, which may not have the means to undertake such an assessment.

This is why we favour a clear convention, in order to avoid any debate on the relevance of the price selected within the bid-ask spread. For simplicity, this convention could be the mid-market pricing, which would limit day-one profits or losses as opposed to a convention consisting of a bid price for assets and an ask price for liabilities.

Illiquid Market

Regarding markets that are no longer active, we would recommend that’s the Board adopts the guidance of the Expert Advisory Panel that would complement the guidance currently incorporated in the Exposure Draft and derived from the FSP 157.

DISCLOSURES

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?
We have concerns on the additional disclosures requested by the exposure draft and consider that they could result in undue cost and effort compared to the additional information provided to users (especially §58 and 60).

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?

Please refer to our other answers.

From our point of view, most differences represent improvements except the in use premise prohibited for financial instrument whereas FAS 157 authorizes it.