EFRAG
European Financial Reporting Advisory Group

29 May, 2007

IASB
30 Cannon Street
London EC4M 6XH
UK

Dear Sirs

Re: Discussion Paper Fair Value Measurements

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Discussion Paper on Fair Vale Measurement. This letter is submitted in EFRAG's capacity as a contributor to IASB's and IFRIC's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issue.

We have structured our response as follows. In appendix 1 we make some general comments about measurement, fair value measurement and the proposals in the Discussion Paper. In appendix 2 we set out our responses to the questions the IASB has raised. The comments made in those appendices are very briefly summarised in this covering letter.

Our main comments can be summarised as follows.

(a) Measurement is a fundamental aspect of accounting and we are pleased to see it is now to be considered within two major IASB projects: the Framework project and this Fair Value Measurements project.

    (i) In respect of the former, in principle, we support the IASB in its view that the overall objective should be to (aa) develop clear and precise definitions of all the measurement bases that are candidates for use in financial statements, and (bb) develop a set of criteria for determining which basis should be used in which circumstance.

    (ii) In respect of the latter we again support, in principle, the IASB's objectives to (aa) establish a single source of *generic* guidance for all fair value measurements required by IFRSs. (We say 'generic' because we believe the fair value measurement requirements of individual standards may in some cases still require additional, specific standards-level guidance and illustrative examples), (bb) clarify the definition of fair value and related guidance in order to more clearly communicate the measurement objective, and (cc) enhance disclosures about fair value.

(b) We note (from paragraph 17 of the paper) that, if the IASB proposes a revised definition of fair value, it will carry out a standard-by-standard review of fair value measurements required in IFRS to assess whether each standard's intended measurement objective is consistent with the proposed definition. We agree that such a review would be necessary; the Fair Value Measurements Discussion Paper is a 'how to measure fair value' paper, and the standard-by-standard review would in effect be a 'when to use fair value' exercise. Such an exercise would of course need to be carried out in the context of and validated against a detailed understanding of the objectives of financial reporting. This, in our view, involves understanding which view of financial position and financial performance the financial statements should portray and which measurement basis is (or bases are) best at portraying that view. Only then can we have a fully informed and coherent debate about the circumstances in which the market-based exit value described in the paper should be used.

(c) We think it is important that this debate about when to use fair value is significantly advanced before issuing any final proposals on the how to measure fair value issue, because it is difficult to comment effectively on the 'how to' issue without also commenting on the 'when to' issue. For example, as we explain in our detailed comments on the paper, we believe it is incorrect to argue that, transaction costs apart, entry price is the same as exit price. This could be a flaw in the 'how to' proposals, but it might just be that in the circumstances in which the IASB is planning to use the market-based exit value measurement basis, entry price *is* the same as exit price (transaction costs apart). Similarly, we think that underlying much of the discussion in the paper and many of its proposals are the assumptions that active, liquid markets exist for most assets and liabilities and some sort of market exists for them all. We do not think that assumption is valid and, as a result, struggle with many of the detailed notions in the paper. Again though it might be that the assumption *is* valid in the circumstances in which the IASB is planning to use market-based exit value.

Waiting for the 'when to' debate to be significantly advanced before issuing the Fair Value Measurements ED ought not to cause undue delay in the work because an ED is expected later this year on the Objectives and Qualitative Characteristics of Financial Reporting and our expectation is that that ED will set out the detailed understanding referred to in (b).

(d) The term 'fair value' is, of course, a generic term for a family of measurement bases. The measurement basis described in the Discussion Paper is a market-based exit value version of fair value and we think that it would be better, for a variety of reasons, to use the label 'market-based exit value' rather than the generic, non-descriptive 'fair value' label.

(e) In that context we welcome the Discussion Paper's publication, because it seeks to develop a clear and precise definition of, and guidance on, that member of the fair value 'family'. However the stated objective is to do more than that; it is to "establish a single standard that provides uniform guidance for all fair value measurements required by IFRSs". Until the 'when to' debate is complete, we will not know whether all the fair value measurements required by IFRS are market-based exit value measurements, so it is not possible to comment yet on whether the paper meets that objective.

(f) As mentioned above, we think that the proposals in the paper are based on some assumptions that are valid only in fairly limited circumstances. As a result, we struggle with many of the detailed notions in the paper. We also find the arguments in the paper in favour of the exit value notion and in favour of a market-based value (rather than an entity-specific value) unconvincing. In particular:

   (i) we do not believe that in all situations the market-based exit price will best reflect the future cash flows; we think market-based entry values and entity-specific values will sometimes reflect those cash flows better.

(ii) we think the paper treats entity-specific measures as more subjective, and therefore less reliable, than market-based measures. Again, we do not think that is necessarily the case particularly where there is no readily identifiable homogeneous “market participant”.

(g) However in order to provide constructive input, we have assumed, in most of our answers in appendix 2, that the objective is to define a market-based exit value notion and provide guidance on how to determine it. Under this assumption, our main comments are as follows:

(i) We have a number of concerns about the notions in the paper of 'market', ‘principal market’ (or in absence of it the ‘most advantageous market’) and the impact of those notions on the market participant notion. As a result, we are not convinced that the market participant notion will work well except in a few limited circumstances (when the market is liquid and supply and demand are in equilibrium). In other circumstances, the notion of market will be difficult to apply consistently and objectively (because different market participants will have different views on market-based value). We are particularly concerned at the suggestion that markets that do not exist should be assumed to exist for the purposes of measurement. We can see plenty of problems with such a suggestion—including issues of reliability—but not many benefits.

(ii) We do not agree that a transfer value notion should be applied to all liabilities. In most cases the settlement 'market' will be the principal market and should in our view be used to derive an appropriate measure. We particularly question the usefulness of a transfer value notion in circumstances in which the entity is legally or contractually not allowed to transfer the liability.

(iii) We support the general idea of a hierarchy, both to prioritise inputs and to introduce a graduated disclosure regime. We do though have some detailed concerns about whether aspects of the FAS 157 hierarchy are sufficiently clear.

If you would like further clarification of the points raised in this letter, either Gregory Hodgkiss or I would be happy to discuss these further with you.

We would, of course, be pleased to participate in any round-table meetings you may hold on the subject.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
Some general comments about measurement, fair value measurement and the proposals in the Discussion Paper

The need for a comprehensive and fundamental global debate about measurement

A1.1 We have, as the IASB knows, been calling for some time now for a comprehensive and fundamental global debate about measurement in financial statements. Measurement issues are at the core of many of the longer-duration projects on which the IASB is now working, and many of these projects will determine the direction in which accounting will develop. The whole point of a fundamental debate on the subject is that a framework can be developed that will help ensure that specific issues are addressed in a coherent way, and that those commenting on proposals can do so against a backdrop that comprises an agreed set of fundamental principles.

A1.2 For that reason, we welcome the fact that the IASB and FASB have now started leading a comprehensive and fundamental global debate about measurement as part of their Framework project. We suspect that the debate will quickly reveal that the measurement 'landscape' is littered with misunderstandings and misconceptions. That is why one of the most useful things that the debate can do is to help all parties to develop a better understanding of each other's thinking and concerns.

A1.3 We also hope that the comprehensive debate will provide the answer to the question: what view are we trying to portray of financial performance and financial position? This question is important because many commentators think that the arguments that have been advanced in favour of current value in general and a market-based exit value version of fair value in particular have to date been flawed or superficial or involved unsupported assertions. For example, some characterise the arguments currently advanced to support the use of a market-based exit value version of fair value as follows:

> The objective of financial statements is to provide users with information about future cash flows…
>
> …and current value tells users more about future cash flows than historical cost measures.
>
> And a current exit value tells users more about future cash flows than a current entry value.
>
> Subjectivity can be an issue with some forms of current value, so it is best to use as much observable data as possible.
>
> That means using market-based exit value measures.

However, although there is no doubt that market-based exit values are excellent at providing information about the cash flows that will arise from an orderly disposal of an entity's balance sheet, most entities' activities are more complex than that and, in such circumstances, what most users are interested primarily in is an entity's ability to generate cash inflows that exceed its cash outflows, and that involves understanding the entity's ability to add value. It is not self-evident to many commentators—including EFRAG—that market-based exit value is the measure to use to portray that ability. Furthermore, different current value systems result in different gains and losses being recognised at different points in the transaction cycle, and therefore provide different views of the financial performance of the reporting entity. Yet, under the characterisation described above, that issue is ignored. Many commentators—again including EFRAG—think that this is wrong; the gains and losses involved are too significant to treat as an unimportant consequence of the search for 'objective measures'. In their view, decisions cannot be taken about the measurement basis or bases to be used in the financial statements until we have decided what view of financial performance and financial position we are trying to portray.

What is 'fair value' and when will its use be required?

A1.4 Broadly speaking, there are, we think, two ways to approach the measurement debate.

(a) One can answer questions like what view of financial performance and financial position should the financial statements be showing and use those answers to devise a measurement basis or bases that enables that view to be given.

(b) Alternatively, one can identify and precisely define all the measurement bases that exist, then see which one or ones are the best at portraying the view of financial performance and financial position that it is decided financial statements should portray.

A1.5 As far as EFRAG is concerned, both approaches are satisfactory. However, if approach (b) is adopted, it is in a sense difficult to comment on the definitions themselves—except to highlight measurement bases that have been omitted or to quibble about the labels used. The key issue is the circumstances in which the IASB believes a particular measurement basis should be applied.

A1.6 From what we understand, the IASB's approach is along the lines described in paragraph A1.4 (b); it is first defining the measurement bases, and will then choose from amongst them. (We say that because the IASB has described the paper as being about 'how to' fair value, not 'when to'; and because the paper contains no arguments or other reasoning that would suggest that the IASB has considered the sort of issues mentioned in the preceding paragraphs.) We would make the following comments on this approach:

(a) as we have just explained it is difficult to comment on the paper's proposed explanation of fair value without knowing the circumstances in which the IASB believes fair value as defined should be applied. For example, we could agree entirely with the definition and explanation of fair value in the paper whilst at the same time believing that there are no circumstances in which it would be appropriate to use that version of fair value in the financial statements.

(b) applying such an approach means developing similar principle-based guidance to the guidance contained in this paper for all other possible measurement bases. 'Fair value' is a generic term covering a range of different measurement bases, and there are probably a number of other current value measurement bases that, though not usually labelled 'fair value', are also candidates for use in the financial statements. They all need to be precisely defined if approach (b) is to be followed.

(c) we are only at the Discussion Paper stage at the moment. We think it is very important that, by the time the 'how to' exposure draft on fair value measurement is issued, all the 'candidate' current measurement bases have been precisely defined and constituents understand to which type of assets and liabilities market-based exit value is to be applied. This will allow constituents to comment more effectively on the definition.

It is perhaps worth mentioning at this point that, depending on exactly what definition of fair value is chosen eventually, it may be appropriate for its use to vary from jurisdiction to jurisdiction. We say this because the degree of sophistication and depth of the various markets involved is not the same—for example, generally speaking, markets are deeper and more fully developed in the US than in parts of Europe—and it seems to us that this ought to have implications for when market-based measures should be used.

Appendix 2
EFRAG's response to the questions raised in the Invitation to Comment

Before answering the questions, we wish to make one further general comment. As our answer to question 3 makes clear, we are not currently persuaded that the fair value that is referred to in existing IFRS should be an exit value in all cases, nor are we convinced it should be a market-based measure in all cases. However, in order to be helpful we have assumed, in answering questions 4 to 27, that the objective *is* to define a market-based exit value, and that the main objective of the exercise is to agree on precisely how that value is best arrived at. All our answers to those questions should be read in that context.

Question 1—In your view, would a single source of guidance for all fair value measurements in IFRSs both reduce complexity and improve consistency in measuring fair value? Why or why not?

A2.1 We believe that, if several standards use the same term, that term should have precisely the same meaning in each case. And, if a term needs a lot of guidance to ensure its meaning is clear and it is applied consistently, it will usually be preferable for that guidance to be gathered together in a single place. Finally, we agree that a single source of clear guidance is likely to reduce the complexity and improve the consistency in measuring fair value. For those reasons we in principle support the reasons why the IASB has issued this Discussion Paper.

A2.2 We are also generally in favour of convergence between IFRS and US GAAP—although we do not support convergence regardless of the cost involved—so we in principle support the IASB's efforts to achieve convergence on this particular issue. (We think though that convergence on meaning will be easier than convergence on usage because we believe that the different degrees of sophistication and depth of markets in different jurisdictions ought probably to mean that fair value as defined in the paper will be used differently in different jurisdictions.)

A2.3 In our view, the guidance provided in IFRS should always be based on a robust set of principles. We believe that the guidance in the Discussion Paper is principles-based guidance.

A2.4 However, for the avoidance of doubt and as more fully explained elsewhere in this letter we do not accept that every—or indeed necessarily any—existing reference in current IFRS to 'fair value' is a reference to fair value as defined in this paper. It might be an appropriate measure when markets are liquid and supply and demand are more or less in equilibrium, but that is rarely the case in the 'real world'.

A2.5 Furthermore, as the Discussion Paper itself makes clear, 'fair value' is a generic term covering a range of different measurement bases. The question asks whether there should be "a single source of guidance for *all* fair value measurements" (emphasis added). We think there should, and therefore encourage the IASB to push on and develop similar guidance to that in this paper for all other measurement bases in the fair value family.

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

A2.6 Although the guidance in FAS 157 is more extensive than the guidance in existing IFRS, we would not necessarily consider it preferable to the material in existing IFRSs. That is partly because in some cases they seem to be describing slightly different measurement objectives or slightly different measurement bases and we think those differences might be appropriate. However, it is also because we think there might remain a role for standards-level guidance that provides guidance and illustrative examples relevant to the application of the particular standard. Furthermore, as explained more fully in our answers to subsequent questions, the guidance in the paper is in our view not always appropriate. Finally, we are also a bit concerned about the length of the generic guidance in FAS 157, particularly within a principle-based system. It might be worth trying to develop some additional principles and sub-principles that would enable the guidance to be shortened.

A2.7 We would also point out that there is some material in the existing IFRSs that require current value measurement—such as that on value-in-use—that is useful. We recognise that value-in-use is not a market-based measure, but think the guidance is useful nevertheless.

A2.8 The Discussion Paper deals extensively with the inputs used to determine fair value but does not appear to deal with the valuation techniques and models in as much rigour, contenting itself with general descriptions of possible valuation techniques. In our view the determination of a reliable fair value on a consistent basis depends on both the inputs and the modelling techniques used. We therefore prefer the current guidance of paragraphs AG74 to AG76 of IAS 39 which we see as being a more balanced approach to laying out minimum requirements for the valuation techniques and inputs

Question 3—Do you agree that fair value should be defined as an exit price from the perspective of a market participant that holds the asset or owes the liability? Why or why not?

A2.9 This question actually comprises two questions:

(a) should fair value be an exit value notion, and

(b) should it be based on the perspective of a market participant that holds the asset or owes the liability?

Exit value notion

A2.10 It is difficult to make firm statements about this issue without knowing what view of financial performance and financial position the financial statements are intended to give, but our current position is that we do not think that fair value should always be an exit value notion.

A2.11 The question of whether fair value should always be an exit price is clearly a very important question, and is one that we think needs to be answered by asking what results in the most useful information for users of the financial statements. Unfortunately, we found the two arguments in the paper in support of exit values unconvincing.

(a) "An exit price objective is appropriate because it embodies current expectations about future inflows associated with the asset…" As we explain in our answer to question 4, we think that entry value also reflects the market's current expectations about future inflows associated with the asset. Furthermore, we believe that in some circumstances value in use can also provide the most useful information for users.

(b) "The Framework defines assets in terms of inflows." Under existing accounting there is not necessarily a link between what something is and how it should be measured. Furthermore, as explained in Appendix 1 (see paragraph A1.3 for example), we do not believe that, just because something represents expected inflows of economic benefits, it follows that the informational content of the financial statements that report those expected inflows is improved by measuring those inflows at the amount that is expected to flow in. In any case, the amount described in this paper as fair value will in many cases not be the amount that is expected to flow in—because it is not entity-specific.

A2.12 There will be some circumstances in which exit and entry values are the same and transaction costs are not significant. In such circumstances it may be acceptable to use the entry value as a proxy for the exit value if it is easier to obtain. However, that is not the norm. In the vast majority of circumstances exit value and entry value are different and/or transaction costs are significant. In those circumstances one of the key issues is when does one switch from an entry value to an exit value. The original transaction will have taken place at entry value, and the final transaction will take place at exit value, but if the item is being measured on a current value basis one has to decide at which point (if at all) prior to the final transaction one should switch from entry value to exit value.

A2.13 Without persuasive arguments, we are left wondering how it can be that, when an entity buys something for €10 that it is pretty sure will generate €12 of value, the most useful information is provided by recognising either:

(a) an immediate gain of €2 (because the entity-specific exit value when it bought the asset was €12) before it has been earned; or

(b) an immediate loss of €2 (because the market-based exit price when it bought the asset was €8) even though logically the entity would not have bought the asset if that exit value was relevant.

A2.14 In our view better arguments than the ones in the paper need to be developed in support of using exit values, at least in certain circumstances (for example perhaps when markets are liquid and the price is elastic so that supply and demand are more or less in equilibrium). However, those arguments will need to take into account that, for many assets, the exit price does not reflect the economic process that takes place within an entity and does not faithfully represent the entity's activities. An example of this is a commercial loan with unique characteristics and no secondary market, where the only market is that of origination. Under IAS 39 these will be subsequently measured at amortised cost. Here the entry price may be more appropriate as it better reflects the estimate of cash flows inherent in the asset. In the absence of an actual market a hypothetical market price does not seem useful for such assets.

A2.15 We are concerned that the analysis that underlies the FAS 157 (and so the Discussion Paper) has been based on the assumption that a liquid market in equilibrium always exists and that the results of that analysis have been extended to other assets and liabilities without considering whether the underlying reasoning still holds in the absence of such a market. In most cases, such a liquid market in equilibrium does not exist. Indeed, as discussed in the section immediately below, often even a market does not exist. The case for exit value needs to be made in terms that both take this into account and are much more persuasive than the arguments in this paper.

Perspective of a market participant

A2.16 EFRAG interprets the words “from the perspective of a market participant that holds the asset or owes the liability” to mean that fair value is not an entity-specific value, but a third-party market participant-based (referred to hereafter as ‘market-based’ for short) value. This raises several concerns in our minds:

(a) We have had a lengthy discussion as to what exactly the paper means when it refers to a ‘market’, and what implications this has for the market participant notion. For example, if an entity, following a business combination, is trying to fair value a brand, should it use its lock-up value, the value a local entity might be prepared to pay, or, for example, the price a multi-national would be prepared to pay? The reality is that in most cases transactions are individually negotiated and the notion of a market and a single market participant view appears to be rather artificial. If there is only one knowledgeable, willing third party concluding a deal in an arm’s length transaction, is that party a “market participant”?

(b) In many other cases the notion will lead to subjectivity because it will be difficult to find a single market. Maybe in that case the best thing to do will be to treat the entity’s customer/supplier as the only market participant. We believe that the IASB needs to explain why it makes sense to value the entity’s assets from the point of view of the other party if there is no intention to sell.

(c) It would appear to us that the main reason that the FASB has chosen a market-based value over an entity-specific number is because it considers market-based numbers to involve less subjectivity than entity-specific values. While that is probably usually the case when an observable market value actually exists, it will often not be the case when observable values are not available and estimation and valuation techniques and adjustments are necessary. We think that, if one looks at assets and liabilities as a whole, there will not be observable values more often than there will. We question whether numbers based on hypothetical transactions on hypothetical markets are really less subjective than an entity-specific measure.

A2.17 We think the only factor that should be considered when deciding whether to use market-based values or entity-specific values is which measurement basis will result in the most useful information. And, if the objective *is* to provide users with information about future cash flows, we would have thought that values that take fully into account the entity’s abilities to generate cash flows from an item will usually achieve that objective better than values that do not take those abilities into account. In the case where no liquid market exists, the reporting entity will generally have better and more detailed information available for determining the expected future cash flows than market participants, particularly if hypothetical transactions are involved. For these reasons we think that, if the IASB is to require the use of a market-based exit value in such circumstances, its reasoning will need to be persuasive.

Question 4—Do you believe an entry price also reflects current market-based expectations of flows of economic benefit into or out of the entity? Why or why not? Additionally, do you agree with the view that, excluding transaction costs, entry and exit prices will differ only when they occur in different markets? Please provide a basis for your views.

A2.18 We think that as a matter of definition both entry price and exit price reflect current market-based expectations of flows of economic benefits. At any point in time, a market participant could be a buyer, a seller or both, but in any case the price at which they will transact will reflect the market participant's expectations of the future flows of economic benefits

A2.19 We do not agree that "excluding transaction costs, entry and exit prices will differ only when they occur in different markets."

(a) We agree that, in any single transaction, the entry price for one party to the transaction will be the same as the exit price for the other party, transaction costs apart. However, most markets are not liquid markets, so there will often not be a single market price but a range of prices which would be acceptable to buyers and sellers. In such circumstances, the entry price on a market will not be the same as the exit price on that market at the same point in time. Bearing that in mind, we think FAS 157 is wrong to claim that entry price is often the same as exit price and that they are interchangeable. In our view they are usually different and to pretend otherwise avoids addressing a key issue.

(b) Another reason that the difference between a market-based entry and a market-based exit price will involve more than just the transaction costs is that those costs relate only to directly attributable costs while the market's expectations will take into account other elements as well; for example, economic rationale (including participants' different assessments of unobservable inputs, different requirements for profit margins and capital remuneration, different views on risk and different objectives pursued).

A2.20 One of our concerns with the debate as a whole is that the paper's conclusions seem to us have been drawn from an analysis of the situation that exists only when there is a liquid market in equilibrium. When such a market exists, many of the issues that trouble us most—differences between entry and exit prices, significant transaction costs, measurement errors, and market imperfections generally—are not significant because they are arbitraged away and can therefore reasonably be ignored. We think that this means the debate is starting from completely the wrong place. Illiquid markets (or even no market at all) are the norm and it is in such circumstances that the most difficult measurement issues arise. The analysis should therefore focus on such markets, and devise measurement solutions that work in that context.

Question 5—Would it be advisable to eliminate the term 'fair value' and replace it with terms, such as 'current exit price' or 'current entry price', that more closely reflect the measurement objective for each situation? Please provide a basis for your views.

A2.21 Although, we think the term 'fair value' has value as a means of distinguishing certain types of current value from cost-based measures, we think – indeed this paper makes it clear – that the term is a generic term that has been used to describe a family of different types of measurement bases other than cost.

A2.22 For that reason and for the reasons below, we strongly support eliminating the term 'fair value' and describing the measurement basis in the Discussion Paper as 'market-based exit value' or something similar.

(a) The term ‘fair value’ has for some considerable time meant different things to different people, and it is always difficult when that is the case to achieve consistency of meaning.

(b) The term carries too much baggage for there ever to be a constructive debate on the subject.

(c) The term is not descriptive. Many values can be described as ‘fair’. It would be more useful if the label itself captured the measurement objective.

A2.23 However, in deciding on a new label, one issue that will need to be considered is whether the label should describe the measurement objective or the measurement method used. For example, if the measurement objective is market-based exit price but for whatever reason it has been necessary to approximate that value by using an entity specific in-use value, should that measure be referred to as ‘market-based exit price’ or as ‘entity specific in-use value’. Our members have different views on this issue. We think this is an issue that could usefully be discussed further with the user community.

Question 6—Does the exit price measurement objective in SFAS 157 differ from fair value measurements in IFRSs as applied in practice? If so, which fair value measurements in IFRSs differ from the measurement objective in SFAS 157? In those circumstances, is the measurement objective as applied in practice an entry price? If not, what is the measurement objective applied in practice? Please provide a basis for your views.

A2.24 Based on our own experience and our discussions with others, our understanding is that most of the fair value references in existing standards are not regarded as references to fair value as defined in this paper (the market-based exit price).

A2.25 In the case of IAS 39 and financial instruments, our impression is that fair value as defined in FAS 157 is currently used in practice only when there is a very liquid market for the item in question and the reporting entity is able to access that market—although sometimes mid-market values are used rather than exit values.

(a) It would appear though that many preparers do not apply notions like ‘principal market’ and ‘most advantageous market’; they simply use the market on which the reporting entity tends to trade.

(b) The application of market-based exit value is however often currently modified when it results in day one profits (and sometimes losses as well) by deferring the immediate recognition in full of those gains and losses. Different practices are adopted, with some entities amortising the gains and losses on a linear basis, and some recognising the deferred day-one gains and losses when the parameters become observable or at the end of the transaction.

(c) Where there is not a liquid market that the reporting entity is able to access, we understand that entity-specific values tend to be used and, when a liability is involved, settlement value is used rather than transfer value.

A2.26 In the case of non-financial assets (including biological assets) and non-financial liabilities, our understanding is that practice is more varied.

(a) That seems to be particularly so when accounting for the assets and liabilities acquired as a result of a business combinations. The impression we get is that for most items the measurement objective is not seen in terms of entry or exit value; rather it is seen in very broad terms simply as market value or an up-to-date and relevant entity-specific value. Adoption of the FAS 157 approach would lead to significant change of practice in this area.

(b) Entity-specific data is widely used because of the lack of liquid markets. An example of this is IFRS 5 where a negotiated price (but not necessarily a definitive contractual price) is often used for an asset held for sale.

(c) In some jurisdictions—particularly those like the Netherlands with a local GAAP that previously required entities now on IFRS to use current cost if a measurement basis other than historical cost is used—entry values rather than exit values are used. We have found no evidence of hypothetical markets and hypothetical market participants being assumed in order to estimate market-based values in the absence of markets.

A2.27 Thus, although up-to-date values are used as required by the standards, the detailed measurement objective seems to differ quite significantly. Market-based measures seem to be used primarily when markets are very liquid and the entity intends to extract value out of the item by selling it; otherwise entity-specific measures seem generally to be used if the item is to be held, and mid-market prices otherwise.

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

A2.28 As already mentioned (see our answer to question 3), we think the wording in FAS 157 is unclear about exactly what the market participant notion entails, although we think the intention behind the standard's definition is clear.

A2.29 We also think that the market participant notion works reasonably well when there is a liquid market with supply and demand broadly in equilibrium. However, where that is not the case we think the notion is more problematic.

(a) When markets are less liquid, there does not tend to be a single price at which market participants transact.

(b) When there is no market—as is more often the case than not—the basis for the notion falls away. There is, for example, neither a principal market nor a most advantage market. And again there is not a single price.

A2.30 We understand the proposal to be that it is unimportant whether there is a market because if there is no market the market participant should be based on a hypothetical market. However, the Discussion Paper seems to assume that there is a liquid market, and as a result little guidance is provided on how an entity identifies the market participants where there is no liquid market (or no market at all). We suspect that this could lead to much subjectivity about the 'market participants' and that that subjectivity—because the market participants an entity has defined will form the basis for determining the fair value—will result in the inconsistent application of fair value measurement standards. This is also a concern for liquid markets as there are several different market participants possible in one market.

A2.31 For example, assume an entity has an intangible asset in the form of a brand name. If the market participant is determined as transacting in a business combination, different types of potential acquirers are possible: consolidators, other domestic trade purchasers, overseas purchasers, private equity investors, etc. They will all have very different perspectives and prospective uses for the brand name. Which market participant should the entity use? During our own discussions it also became apparent that there is some confusion as to whether (and, if so, in what circumstances) customers are to be treated as market participants.

A2.32 For all these reasons we support the market participant view in FAS 157 when there is a liquid market (and on which the price is sufficient elastic so that supply and demand are more or less in equilibrium), but when there is no such market we do not think the notion really works. We are however not sure whether this is a comment about the 'how to' guidance or a comment on when the market-based exit value described in the paper is an appropriate measurement basis to use.

Question 8—Do you agree the market participant view in SFAS 157 is consistent with the concepts of 'knowledgeable, willing parties' and 'arm's length transaction' as defined in IFRSs? If not, how do you believe they differ?

A2.33 We think that they will usually be consistent, but not always. For example, related parties are not market participants because FAS 157 requires market participants to be independent of the reporting entity; the concepts of 'knowledgeable, willing parties' and 'arm's length transactions' in IFRS are generally seen as less restrictive than that.

Question 9—Do you agree that the fair value of a liability should be based on the price that would be paid to transfer the liability to a market participant? Why or why not?

A2.34 No we do not; although we have found it difficult to articulate the reasons why we think transfer value is not an appropriate measurement basis for liabilities without straying into 'when to' issues. Assume that an entity incurs a liability in the current reporting period that it intends to settle (by making payments with a net present value of €100) in the next reporting period. Assume also that the transfer value on or immediately after initial recognition is €110. If the liability was measured at transfer value a loss of €10 would be incurred in the current period, and a profit of €10 in the next period. The proposal in the paper is that recognising these gains and losses would improve the information provided to users. If we understood what the detailed information objective was in fair valuing liabilities (or to be precise, valuing liabilities on a market-based exit value basis), we could judge more easily whether transfer value or settlement value best meets the objective. This emphasises the importance of having fully reasoned 'when to' material available by the time the material in this Discussion Paper is issued as an Exposure Draft.

A2.35 In the absence of such material, all we can really do at this stage is comment on the differences between the approaches and contrast them with the approach being proposed for assets.

A2.36 We see the main difference between the transfer and settlement approaches being that transfer value will include a margin that the transferee will require for entering into the transfer (a profit margin) whilst the settlement value generally will not.

We say "generally will not" for several reasons. First of all, it is sometimes possible to settle a liability by transferring it. In those circumstances settlement value will of course be the same thing as transfer value. Secondly, there is more than one settlement approach and, although an approach based on settlement at full term under normal conditions would not involve a margin being paid to achieve settlement, an approach based on immediate settlement even though settlement is not due (the so-called current settlement approach) might perhaps involve such a margin. Thirdly, it has been suggested to us that the settlement value of a performance obligation might involve a profit margin. This is something we will no doubt consider further in the context of the recently issued IASB Discussion Paper on Insurance Contracts.

We think usually it would not be appropriate to incorporate someone else's profit and risk margin in the valuation of one's own liabilities. That is particularly so when there is no intention of transferring the liability, when the entity is contractually or legally not allowed to transfer the liability involved to a third party, or when no transfer market for that particular liability exists, as is the case with some provisions. In those circumstances it seems to us particularly important that the market-based exit price is based on settlement rather than on the transfer of the liability.

A2.37 We are also wondering how this issue fits with the need to focus on the principal market (of, if there is no such market, the most advantageous market). Is it the intention that we should look for the principal (or most advantageous) transfer market? We have difficulty reconciling the reasoning underlying these two market types with what is said about liabilities because we think of both transfers and settlements as market transactions.

A2.38 We also wonder how the notions apply when, for example, market participants determine the fair value of liabilities based on the reporting entity's specific information, as is often the case during a due diligence exercise. Market participants generally assume in such exercises that the entity-specific information is more accurate and relevant than market-based information.

A2.39 Finally, we disagree with the implication in paragraph 23 that existing IFRSs already require a transfer value approach to be applied to liabilities. IAS 39 paragraph 9, for example, makes it clear that the fair value of a liability is its settlement value.

Question 10—Does the transfer measurement objective for liabilities in SFAS 157 differ from fair value measurements required by IFRSs as applied in practice? If so, in practice which fair value measurements under IFRSs differ from the transfer measurement objective in SFAS 157 and how do they differ?

A2.40 Based on our own experience and discussions with others, our understanding is that liabilities are usually measured using a settlement measurement objective; unless either the creditor intends to transfer the liability or an easily accessible liquid transfer market is available, in which case a transfer value is sometimes used. It is, for example, quite common to see a market-based exit value being used when the fair value option is being applied to the measurement of liabilities.

A2.41 The reason why liabilities are usually measured using a settlement measurement objective seems to be because a market rarely exists, most liabilities are actually settled not transferred, and a measure that is based on a hypothetical transfer that will not take place is generally deemed not to be relevant. Financial liabilities seem to be no different: the definition of fair value in IAS 39 refers to the amount for which the liability could be settled and our understanding is that financial liabilities are usually measured initially at the transaction price and subsequently measured at the net present value of the forecast cash flows. The exception to this is, as already mentioned, where either the creditor intends to transfer the liability or an easily accessible liquid transfer market is available.

Question 11—In your view is it appropriate to use a measurement that includes inputs that are not observable in a market as fair value at initial recognition, even if this measurement differs from the transaction price? Alternatively, in your view, in the absence of a fair value measurement based solely on observable market inputs, should the transaction price be presumed to be fair value at initial recognition, thereby potentially resulting in the deferral of day-one gains and losses? Please give reasons for your views.

A2.42 For the avoidance of doubt, we wish to make it clear that we are not yet persuaded that, except where existing IFRS requires it, anything other than transaction price should be used on initial recognition. We recognise that this is an entity-specific entry value and, if the general measurement objective is market-based exit value, a 'switch' from entity-specific entry value to market-based exit value has to take place at some point, but we have so far not heard any conceptual arguments that convince us that that 'switch' should be on initial recognition.

A2.43 Furthermore—and as we have already explained—we do not believe that in most cases entry value and exit value are the same, transaction costs apart. For that reason, we also question FAS 157's assumption that in most cases the entry price at initial recognition equals the exit price. Indeed, we are concerned that, by making that assumption, an important part of the measurement debate has been assumed away.

A2.44 Although we have tried to put those points aside so that we can answer the question, we find it difficult to separate the 'when to' issues from the 'how to' issues. However, we make the following observations:

(a) One has to be clear as to why the market-based exit value has been chosen over, say, entity-specific value in order to be able to say whether it is appropriate to use a measurement that includes non-observable inputs on initial recognition. If the only reason is that, generally speaking, market-based exit values are more reliable or less subjective, we do not think that is sufficient reason to use non-observable inputs when a current observed transaction price is available. However, if market-based exit values are being used because, say, it is important that the measurement basis is independent of the reporting entity, non-observable inputs might be appropriate as long as they are themselves independent of (or maybe no more dependent on) the reporting entity.

(b) The issue of day one profits and losses is important and must not be avoided (by assuming entry value equals exit value, by treating it as an unimportant technical detail or by not addressing what happens on day two). It is at the centre of the initial measurement debate and the definition of fair value, and crucial to the principles of profit recognition. Our current—and very tentative view—is that one should use on initial recognition the measurement bases that is conceptually the most appropriate basis to use; however, in deciding on the most appropriate basis, one needs to consider whether a basis would result in day one profits or losses because, if it does, that would be appropriate only if those day one profits or losses can be demonstrated to be attributable to the initial transaction rather than to some subsequent action which the entity needs to take. It is wrong, in our tentative view, to decide that it is appropriate to apply a particular measurement basis only to defer recognition of one of the results of its application—day one profits and losses.

Question 12—Do you believe that the provisions of SFAS 157, considered in conjunction with the unit of account guidance in IAS 39, would result in a portfolio-based valuation of identifiable risks of instruments considered in aggregate, or an in-exchange exit price for the individual instruments? Please give reasons for your views.

A2.45 EFRAG believes that defining the unit of account and the unit of measurement is a crucial part of the process, and raises the same issue about recognition of day one profits and losses that we raised in paragraph A2.44. The notions need to be clearly defined if inconsistency is to be avoided. We were as a result disappointed about the relative lack of guidance on the subject in FAS 157. We also do not find IAS 39 very helpful on the issue.

A2.46 However, based on our own experience and discussions with others, we understand that currently many entities believe that IFRS allows portfolio-based valuation of identifiable risks of instruments considered in aggregate. For example, in many cases entities value structured products (for instance a combination of some 'basic' derivatives, a loan with an embedded derivative, etc) for the purposes of IFRS on the basis of portfolios of identifiable risks rather than on an in-exchange exit price basis. Entities are measuring such structured products by splitting the contract into its constituent parts, which are measured using appropriate inputs. Portfolio-level adjustments are then made to reflect elements such as liquidity and counter-party credit risk. As a result, the valuations are an aggregate of component-, instrument- and portfolio-level measures and adjustments. This could involve inputs at various levels of the fair value hierarchy and therefore would require allocation of the portfolio adjustments for the purpose of presentation and disclosure. This could potentially result in very detailed and onerous disclosures where level 3 inputs are used. More detailed guidance about the use of judgement in the assessment of the relative importance of the input levels would be required to aid preparers.

A2.47 These portfolio-based valuation techniques are employed in order to take into account, through valuation adjustments, certain risks that are not considered by the valuation techniques commonly used by market participants to price the instrument. For instance, Interest-Rate Swaps are commonly priced using inputs that correspond to an AA credit rating, regardless of the actual credit rating of the counterparty. Therefore, in order to estimate fair value that price is adjusted. With a single counterparty, however, the entity can have more than one position, some with positive fair value (asset), and others with negative fair value (liabilities). In order to represent the actual risk for the entity, the adjustment for credit risk is determined on a portfolio basis by netting positions with positive fair value and positions with negative fair value. In particular, a credit risk adjustment is calculated only for net positions with positive fair value. The same reasoning applies to other kind of risk/components of fair value such as adjustments for determining the bid/ask spread.

Question 13—Do you agree that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability? Why or why not?

A2.48 It is our understanding that FASB initially thought that the focus should be on the most advantageous market, but it agreed for pragmatic reasons to shift that focus to the principal market. We do see problems in the standard requiring entities to focus on the most advantageous market, and we welcome the attempt to address those problems.

A2.49 We also agree that it will sometimes be the case that the principal market will also be the most advantageous market, particularly when the most advantageous market is very liquid.

A2.50 However, in order to answer the question posed, we need to put those issues aside. We would expect a careful analysis of the detailed objectives of financial reporting (see our earlier comments) to provide a clear indication as to whether market-based exit price should be based on the principal market, the most advantageous market or some other market. However, if that analysis does not provide a clear unambiguous answer, we think a pragmatic approach should be adopted. In that circumstance, we agree (as we have explained above) that the approach described in the paper is better than focusing just on the most advantageous market. However, we think that focusing on the market that an entity usually uses would be even better because that would generally be less burdensome.

Question 14—Do you agree that a fair value measurement should consider attributes specific to the asset or liability that market participants would consider in pricing the asset or liability? If not, why?

A2.51 If one is trying to provide guidance on how to determine a market-based exit value, we agree that it is necessary to consider such attributes.

A2.52 However it is issues like this that lie behind our concerns about requiring the widespread use of the market-based exit value version of fair value. That is because we do not understand why the information is more useful because it takes into account attributes that market participants would consider, but the reporting entity might not.

A2.53 On a practical level, in absence of liquid markets, we suspect it may be difficult to identify which attributes the market participants would consider in pricing. As a result, practice is likely to be inconsistent, and that may have a considerable impact on the determined fair value.

Question 15—Do you agree that transaction costs that would be incurred in a transaction to sell an asset or transfer a liability are an attribute of the transaction and not of the asset or liability? If not, why?

A2.54 We struggle with the question as currently phrased. It seems to us that one first determines the asset to be measured, then one determines the measure. The “asset” to be measured will take into account the attributes specific to the asset, and we agree that those attributes do not include transaction costs. However, the measure might still take into account transaction costs—it depends on how the measurement basis is defined—and those transaction costs might highlight a particular attribute.

A2.55 We also note that transaction costs take different forms and may warrant different treatment. For example, some transaction costs are unavoidable, would need to be incurred by all market participants, and are in effect a cost incurred to make the economic benefits embodied in the asset accessible. We think it might be reasonable to treat such transaction costs differently from other transaction costs.

Question 16—Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value of a liability? If not, why?

A2.56 Our primary concern about allowing changes in own credit risk to affect measures that are used in the primary financial statements is that users will generally, we understand, look to reverse out of the income statement gains and losses arising from changes in own credit risk, and for many purposes the balance sheet numbers are adjusted too. In other words, it is our understanding that users do not generally find the information useful.

A2.57 We think the usefulness of the resulting information should be the ultimate test of any proposed change and allowing changes in own credit risk to affect the measures used in the primary financial statements seems to fail that test. We have of course heard the more technical arguments for and against taking credit risk into account many times, but those arguments seem irrelevant in the context of this failure to meet the ultimate test.

A2.58 Maybe that simply means that a measure that takes changes in own credit risk into account should be rarely if ever used. Alternatively it might mean that fair value needs to be defined so as to exclude such changes.

A2.59 It might be useful to explain more fully which other types of risks, beside credit risk, are included in the definition of 'non-performance risk'.

Question 17—Is it clear that the 'in-use valuation premise' used to measure the fair value of an asset in SFAS 157 is different from 'value in use' in IAS 36? Why or why not?

A2.60 Yes, we think it is clear that the concepts are different, largely for the reasons given in paragraph 45 of the Discussion Paper.

A2.61 In principle we support the notion of an 'in-use value', because there was a risk without it that fair value as defined would be a disposal value even when every one agreed that disposal was a sub-optimal exit strategy. This notion is consistent with IAS 39 paragraph AG 69. We are concerned though that in many cases it will be difficult to determine an in-use value without using entity-specific inputs, and in view of that wonder whether it might be better to simply allow the use of entity-specific values in certain circumstances.

Question 18—Do you agree with the hierarchy in SFAS 157? If not, why?

A2.62 Again in principle we support the use of a hierarchy to prioritise inputs. We also support the use of a hierarchy to introduce a graduated disclosure regime, assuming the hierarchy chosen is suitable for that purpose. We also agree with the description of level 1 inputs. However:

(a) although the assumption underlying the hierarchy chosen and the graduated disclosure regime in FAS 157 seems to be that level 1 inputs are more reliable than level 2 inputs and level 2 inputs are more reliable than level 3 inputs, that is in fact not the case. For example:

(i) some data are very reliable but when adjusted to reflect the particular circumstances of the entity's population might be classified as level 3 inputs; and

(ii) estimates derived from hypothetical markets could, we think, be classified as level 2 inputs even though they could be subject to significant uncertainty.

(b) we note that some of the adjustments the standard could require to be made to level 3 inputs would make them even more subject to uncertainty than they were before. We wonder in the circumstances whether such adjustments are worth making.

(c) we understand that there are concerns about how the categorisation process will work in practice.

For example, in preparing this letter it became clear that different views exist as to whether mortality rates are level 2 inputs or level 3 inputs.

Another example that has been brought to our attention involves an equity-linked note where the underlying is a basket of equities. We understand that the market-based exit value of the individual equities within the basket is observable (probably level 1 inputs) but the overall correlation between the different equities will be unobservable (level 3 inputs) because no similar baskets are traded in the market. The correlation between the equities determines how much of the instrument's value to the issuing entity will be created on day 1. This means that this correlation is significant in the context of the definition of the hierarchy and will often result in the whole instrument being within level 3 of the hierarchy. However, the equity correlation will usually be a fairly constant factor and not in itself generate profit or loss after day 1. Day 2, and later, profits or losses will be generated primarily by changes in the observable equity prices within the basket (level 1 inputs). In such an example, it seems misleading to include the instrument within the level 3 disclosures because that would imply a greater degree of uncertainty or approximation about the entity's post-day 1 results than in fact is the case.

Finally, we have been given the example of an entity that is actively trading a position. The entity can close the risk acquired through products classified as level 3 by using instruments classified in levels 1 or 2 of the hierarchy. The resulting net day-one profit or loss recognised will be made up of products belonging to different levels of the hierarchy.

Question 19—Are the differences between the levels of the hierarchy clear? If not, what additional information would be helpful in clarifying the differences between the levels?

A2.63 Conceptually, the differences are clear but we have our doubts as to whether it will be as straightforward in practice. For example, our discussions show that there are differences of view as to what is 'observable' and what is 'non-observable'. We also understand from our discussions that the categorisation requirements may not be being consistently applied and that FAS 157's requirements are coming under pressure from preparers looking to reduce the number of fair values that are classified as level 3 measures. The criteria might not be robust enough to stand up to this pressure.

Question 20—Do you agree with the provision of SFAS 157 that a blockage adjustment should be prohibited for financial instruments when there is a price for the financial instrument in an active market (Level 1)? In addition, do you agree that this provision should apply as a principle to all levels of the hierarchy? Please provide a basis for your views.

A2.64 The way in which blockage factors are dealt with in the measurement process should depend on the detailed objectives of financial reporting and those objectives' implications for the measurement objective and on the unit of account and unit of measurement chosen. We said earlier that we do not think there is enough material on these issues in the paper; as a result, we are not sure which approach to blockage factors would be most consistent with the underlying objectives of financial reporting and of the measurement basis being defined. For example, if as a result of that analysis the conclusion is that we need to fair value the portfolio as a portfolio, we think that would mean that blockage factors should if possible be taken into account. It would also mean that the value of the portfolio on the price per individual financial instrument multiplied by the number of shares will usually be only a very approximate estimate of the fair value. That would be the case regardless of whether level 1 inputs are being used.

A2.65 We think that, if it is concluded from the analysis that blockage factor adjustments are not allowed, the fair value definitions might not be consistent with Business Combination Phase II proposals. That might not matter of course, because the IASB might decide not to use fair value as defined in accounting for business combinations. This is why it is important that the IASB determines in the exposure draft for which assets/liabilities the concept of market-based exit price is applicable.

A2.66 The FASB has often argued that it is not practicable to allow blockage factors to be taken into account because one cannot estimate reliably what adjustments are needed to do so. In our view, it is usually easier to estimate the adjustments needed to take account of blockage factors than it is to estimate some of the other numbers this standard requires to be estimated.

Question 21—Do you agree that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances, as prescribed by paragraph 31 of SFAS 157? Alternatively, do you believe that the guidance contained in IFRSs, which generally requires assets to be valued at the bid price and liabilities at the ask price, is more appropriate? Please explain the basis for your view.

A2.67 In our view the difference between the bid price and the ask price is a transaction cost. Therefore, anything decided in the context of bid-offer spreads should also be applied to transaction costs, and vice versa.

A2.68 The FASB is right to be cautious about using quoted bid and ask prices when many entities are actually able to transact at prices within the spread. On the other hand, if market-based exit value is what is being defined and that value is to be determined by reference to the views of market participants that are independent of the reporting entity, then it is not clear to us why the reporting entity's ability to transact within the spread is relevant. Yet our instinct is that it *is* relevant; which suggests to us that the principle may not be appropriate.

A2.69 Finally, we have noted that, when bid-offer spread issues are discussed, they are often described as being of less importance than some of the other issues discussed in the paper. If they are genuinely second order issues, we think weight should be given to existing practice in this area.

Question 22—Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed even when another price within the bid-ask spread might be more representative of fair value? Why or why not?

A2.70 We do not know what the phrase 'more representative of fair value' means, but we assume this question in effect asks whether it is better that everyone deals with bid-offer spreads in the same way or that they are given flexibility to select the price within the spread that best reflects the market-based exit value. If the aim is to have consistent fair values, a pricing convention should be imposed. If the aim is to meet the information objectives as best we can, entities should be required to select the price that best reflects the market-based exit value. And, if this is an overly detailed issue, choice should be allowed and one of the choices should be to apply a pricing convention.

A2.71 If a pricing convention were to be allowed, we would be in favour of that pricing convention being mid-market price. We recognise that few, if any, entities trade at mid-market prices, but nevertheless believe it is not burdensome and addresses adequately the mis-match issues that could otherwise arise on matched positions.

Question 23—Should bid-ask pricing guidance apply to all levels of the hierarchy, including when the fair value measurement includes unobservable inputs? Why or why not?

A2.72 We refer to our reply on question 21.

Question 24—Do the disclosure requirements of SFAS 157 provide sufficient information? If not, what additional disclosures do you believe would be helpful to users and why? Alternatively, are there disclosures required by SFAS 157 that you believe are excessive or not beneficial when considered in conjunction with other disclosures required by IFRSs? Please provide a basis for your view.

A2.73 At this stage we believe it is too early to conclude on the level of disclosure required. The requirements of FAS 157 have of course been developed in the context of US GAAP and will therefore have to be adapted to take into account, and harmonise with, IAS 32 and IFRS 7. Having said that, the disclosure requirements in respect of level 3 inputs in particular do seem to be burdensome, as indicated in paragraph A2.46 in our response to Question 12, and certain of our constituents have indicated that they do not believe them to be very useful. We would therefore encourage the Board to consult widely with preparers and users in the next stage of this project to ensure that the disclosure requirements developed result in useful, but not duplicative, information.

Question 25—Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply under IFRSs? If not, please specify what additional guidance you believe is needed and why.

A2.74 As will be clear from what we have said already, EFRAG believes illustrative examples should be included to reinforce the general principles in the following areas amongst others. Those examples should deal with :

(a) How the market-based exit value in case of non-liquid market or in absence of a market should be determined (see paragraph A2.15)

(b) The implications a 'market' has—or the case where no single market can be defined—for the market participant notion (see paragraph A2.16)

(c) What other types of risk other than own credit risk is included in the definition of non-performance risk (see paragraph A2.59)

(d) The distinction between observable and non-observable input see paragraph A2.63)

Question 26—Does the guidance in Appendices A and B of SFAS 157 sufficiently illustrate the standard's principles and provisions as they would apply in emerging or developing markets? If not, please specify what additional guidance you believe is needed and the most effective way to provide this guidance (for example, through additional implementation guidance or through focused education efforts).

A2.75 We think that the guidance is much better at illustrating how the standard's principles and provisions should be applied to financial instruments than to other assets and liabilities. Even then it seems to assume that the liquid markets with supply and demand in equilibrium exist, when in the vast majority of cases there is either an illiquid market or no market at all. This means there will be practical difficulties in applying many of the notions in the standard (for example determining the market participants, the principal market, and in-use and in-exchange values). The guidance does not help much in understanding how those difficulties are best overcome.

Question 27—Please provide comments on any other matters raised by the Discussion Paper.

A2.76 As we mentioned at the beginning of this letter, we do not believe that any decisions can be taken about the circumstances in which fair value as defined in the paper should be used without greater analysis of what it is we are trying to achieve through financial statements. The absence of such an analysis means that the IASB is asking its constituents to comment on the merits of a particular definition and set of explanations in something of a vacuum. That is difficult and, as a result, we think it important to understand that views might change as it becomes clearer how the IASB intends to use the definition.