MASB MALAYSIAN ACCOUNTING STANDARDS BOARD
LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA

7 October 2009

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London ED 4M 6 XH
United Kingdom

Dear Sir David

IASB EXPOSURE DRAFT – FAIR VALUE MEASUREMENT

The Malaysian Accounting Standards Board welcomes the opportunity to provide comments on the IASB Exposure Draft – Fair Value Measurement (ED).

We appreciate the IASB's initiative to develop a single, unified definition of fair value, as well as further authoritative guidance on the application of fair value measurement in inactive markets. The desire to provide users of financial statements with consistent, comparable and understandable information is a constant challenge that our Board shares with the IASB.

Having considered the proposals set out in the ED, we have concerns on the following:

1) we do not believe a general guidance on the application of fair value measurement is appropriate for all types of assets. What is needed is specific guidance on the different types of assets due to their different nature. For example, the valuation of financial asset and non-financial asset will require different guidance given the fact that their attributes are different. In this regard, we have significant concerns applying the highest and best use notion in the fair value of certain non-financial assets such as fair valuation of land recognised as property, plant and equipment of the reporting entity. Current use values provide the most useful information to users about the entity's future cash flows. Therefore, to use a value based on other than current use would be confusing to users. In addition, we are concerned about any potential manipulation, for example earnings management, that may arise from the notion of highest and best use which will most likely require the use of judgement by management.

2) inclusion of credit risk in the measurement of liabilities can mask a deteriorating situation, especially in current market conditions.

3) Level 3 measurement based on unobservable data for unquoted equity instruments would be problematic in practice as the cash flows are based on expectation of management and the discount rate cannot be easily obtained from the market that would make the result of Level 3 valuation highly questionable.

Our detailed responses are enclosed in the Appendix of this letter.

If you need further clarification, please contact Ms Tan Bee Leng at +603 2240 9200 or by email at beeleng@masb.org.my.

Thank you.

Suite 5.2, Level 5, Wisma UOA Pantai, No. 11, Jalan Pantai Jaya, 59200 Kuala Lumpur
Tel : (603) 2240-9200 Fax : (603) 2240-9300 E-mail : masb@masb.org.my Website : www.masb.org.my

Yours sincerely,

Mohammad Faiz Azmi
Chairman

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Question 1 – Definition of fair value and related guidance

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 agree with the proposed fair value definition subject to our response to Questions 5 and 8.

Nevertheless, in determining the notion of fair value, a strict approach may be necessary especially in markets that are shallow or inactive. In such situation, there may be a tendency to skew towards the use of entity specific value in the absence of available relevant inputs to valuation techniques under Level 3 as mentioned in our response to Question 10. In this regard, sufficient guidance for applying the fair value concept for Level 3 category should be provided.

Question 2 – Scope

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?

The fundamental purpose of the proposed Standard is to provide "one reference source" for fair value measurement. Any divergence from this objective would defeat the purpose of a Fair Value Measurement Standard that provides the common measurement principles. While there can only be one set of common principles in fair value measurement, there can be different guidance and methodologies on the measurement, depending on the characteristic of the assets and liabilities. For example, determining fair value of biological assets can be very different from financial instruments, but both should be based on the same basic principles encompassing fair value measurement. Practical guidance can be included in the Fair

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Value Measurement Standard on how to execute the principle in practice based on different circumstances and characteristic of the assets and liabilities.

Thus, any valuation that is not consistent with the definition of the proposed Standard shall not use the term 'fair value'.

Question 3 – The transaction

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 believe that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of which then the most advantageous market for the asset or liability [similar to the position taken by the IASB in the DP]. Whilst in most cases the principal market would be the most advantageous market, it may not necessarily always be the case as at times, an entity could transact in a less advantageous market perhaps for strategy reason rather than maximisation of profit.

In addition the use of the most advantageous market can be swamped with difficulties and ambiguities such as the need to seek out the most advantageous market (notwithstanding the proposed standard does not require the entity to undertake an exhaustive search of all possible markets) and perceived accessibility to the most advantageous market.

Question 4

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

Is the description of market participants adequately described in the context of the definition? Why or why not?

We agree with the Board's description of market participants. Paragraph 13 does adequately describe the traits of market participants. However, paragraph 14 does pose a challenge to apply in practice whereby the entity would need to exercise significant judgment in determining the market participants' perspective in situations where the current use of the asset is not the same as the highest and best use.

For example, if the current use of a bundle of assets coupled with expertise of the entity's management can produce a value that is higher than what market participants would give for the asset individually, it appears the proposed standard condones the use of entity specific value. In this regard, specific guidance on how to determine the perspective of market participants should be developed in the proposed standard.

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Question 5

The exposure draft proposes that:

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

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

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

Are these proposals appropriate? Why or why not?

We agree that the notions of highest and best use and valuation premise are not for financial assets and other liabilities as they generally do not have alternative use.

At the same time, we have significant concerns in applying the highest and best use notion in the fair value of certain non-financial assets. Although we agree with the proposed definition of fair value, we do not believe it is appropriate to broadly apply the concept to all types of non-financial assets.

We believe the nature of the non-financial asset should be given due consideration in applying the notion of highest and best use. For example, whilst it may be apt to apply the concept to investment property, we believe it is not appropriate to fair value property, plant and equipment such as plantation / factory land assuming its highest and best use by market participants that is different from its current use. For example land used for agricultural, residential or commercial purposes would have differing best use values. We are doubtful of the wisdom of imputing a value to the plantation / factory land that is different from its current use because, in our view, current use values provide the most useful information to users about the entity's future cash flows. Therefore, to use a value based on other than current use would be confusing to users.

In addition, we are concerned about any potential manipulation in earnings management that may arise from the notion of highest and best use which will most likely require the use of judgement by management.

In this regard, we strongly urge the Board to reconsider the applicability of highest and best use notion to all non-financial assets.

However, should the Board decide to proceed with the proposals despite the concerns raised, more prescriptive guidance may be required in applying the notion of highest and best use to mitigate the potential manipulation that may arise.

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Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions).

Is the proposed guidance sufficient and appropriate? If not, why?

As mentioned in our response to Question 5, we believe it is not appropriate to broadly apply the notion of highest and best use to all non-financial assets. The guidance in paragraphs 20 and 21 would have to be changed accordingly should the Board agree with our proposal.

Question 7 - Application to liabilities: general principles

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 (for example a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).

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

(a) Conceptually if a liability has no restriction by covenant or law to restrict its transfer to a market participant (transferee) who will assume the obligation for the remaining term to the liability to maturity, the observed price for such transfer in the market would be the best estimate of fair value. However, we note that it is not appropriate for the proposed standard to assume this will always be the case. We believe consideration should be given to situations when transfer of liability is restricted by law. To this, it may not be appropriate

to require entities to use a hypothetical value that will not crystallise in place of the contractual value.

(b) **In our view it is not appropriate to presume the fair value of a liability will always equal to the fair value of the corresponding asset. We believe different market participants may hold different views because of the effect of non-performance risk as mentioned in our response to Question 8.**

For example, in a situation where the collateral is higher than the amount of the liability, the holder is not exposed to issuer's non-performance risk and may thus price the corresponding asset using a lower discount rate (ie risk-free rate). In this situation, the fair value of the liability from the perspective of the issuer will not be the same as the holder.

(c) **We agree with the proposal.**

In addition we disagree with the proposals in paragraph 26. In our view, there may be situations the corresponding asset may not be measured at fair value hence it would not be the appropriate to use that basis to measure the fair value of the liabilities in the book of the issuer.

Question 8 - Application to liabilities: non-performance risk and restrictions

The exposure draft proposes that:

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

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

Are these proposals appropriate? Why or why not?

(a) **We disagree with the proposals to include the entity's own credit risk in the fair value of liability as it would be counter-intuitive, confusing to users and would not provide meaningful information (for example reporting gain when there is a decline in credit quality). To this, reporting a gain from a decline in credit quality can mask a deteriorating situation, especially in current market conditions.**

Whilst we note that the IASB is addressing the issue in another project and has requested for comments with regards to the usefulness of including credit risk in liability measurement via Discussion Paper: *Credit Risk in Liability Measurement* (DP), we are concerned that including it in fair value measurement for liabilities will inevitably require application upon adoption regardless of the outcome of the DP.

(b) **Please see our response to Question 7(a).**

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Question 9 - Fair value at initial recognition

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 disagree with paragraph D32. In our view, the fair value of an asset at initial recognition should equal to the transaction value whilst the fair value of a liability should equal to the settlement value.

For example, if an entity holds a large number of similar assets (for example equity securities), the fair value measurement should include the blockage factor as the entity need to pay a premium to obtain control and hence, block holding should have a higher value than that of quoted market price.

In addition, since financial liability with demand feature is excluded from the requirement of fair value, we see no reason why block holding is not prescribed similar treatment.

Question 10 - Valuation techniques

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples).

Is this proposed guidance appropriate and sufficient? Why or why not?

We agree with the proposed guidance as it provides further authoritative guidance on the application of fair value measurement.

However we would like to express our reservations with regards to Level 3 measurement based on unobservable data. This method generally work well where the cash flows are deterministic and the discount rate can be extrapolated directly from the market for example unquoted bonds. But to apply unobservable data to unquoted equity instruments would be problematic in practice as the cash flows are based on expectation of management and the discount rate could not be easily obtained from the market without undue mathematical adjustment via Capital Asset Pricing Model (CAPM) with gearing and ungearing of beta to find the cost of equity and cost of debt to derive at the weighted average cost of capital. This would make the result of Level 3 valuation highly judgemental.

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Question 11 - Disclosures

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 agree with the proposed disclosures. However, as mentioned in our response to Question 10, the result of Level 3 valuation could be highly judgemental. Therefore, extensive disclosures would be required to mitigate the shortcomings of Level 3 valuation. In this regard, we propose to require disclosure of gross unrealised gains and gross unrealised losses for the period recognised in profit or loss and the basis of determination of these unrealised gains and losses related to assets and liabilities measured using Level 3 inputs held at the end of the reporting period.