Accounting Standards Board of Japan (ASBJ)

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International Accounting Standards Board
30 Cannon Street
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Dear Sirs,

Comments on Discussion Paper "Fair Value Measurements"

We welcome the opportunity to comment on the Discussion Paper "Fair Value Measurements." The views expressed as follows are those of the International Issues Standing Committee of the Accounting Standards Board of Japan (ASBJ).

1. General Comments

1. We support the objective of the Fair Value Measurements project that is to codify, clarify and simplify existing guidance that is dispersed widely in International Financial Reporting Standards (IFRSs) by establishing a single source of guidance for all fair value measurements required by IFRSs.

2. However, we are of the view that the following considerations have to be taken into account when deliberating further on the guidance for fair value measurements in the future.

   (a) We strongly support the IASB's position, reflected on the Discussion Paper (DP), that the Fair Value Measurements project is not a means of expanding the use of fair value in financial reporting. We believe that the position should be maintained firmly in the future deliberation process.

   (b) For ensuring sufficient deliberation for establishing fair value measurement guidance, it is desirable that issues such as the scope of fair value measurement and accounting treatment of the change in fair value in financial statements be also discussed, before establishing the guidance. Specifically with respect to the former issue, deliberation on the measurement guidance should be made in consideration of the discussion in the Conceptual Framework project regarding when fair value should be chosen as a measurement attribute and what the

objectives of financial statements are.

(c) We are of the view that there are several cases where an entry price rather than an exit price should be used for fair value measurement currently required by IFRSs (e.g. fair value measurement at initial recognition and in a business combination; please see our comments regarding the Q3～Q5 of Issue 2). If fair value is to be defined as an exit price, the measurement guidance based on the DP should be applicable only for cases in which an exit price is an appropriate measurement attribute, and the IASB should consider preparing separate measurement guidance for an entry price.

3. We would like to make comments on the following selected questions, hoping that these comments are helpful to the future deliberation process of the IASB.

2. Comments on Selected Questions

Issue 1. SFAS 157 and fair value measurement guidance in current IFRSs

Q1 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?

Q2 Is there fair value measurement guidance in IFRSs that you believe is preferable to the provisions of SFAS 157? If so, please explain.

Issue 12. Application guidance

Q25 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.

4. We agree that a single source of guidance for all fair value measurements in IFRSs would both reduce complexity and improve consistency in measuring fair value.

5. However, we believe that, even though a single source of guidance is established based on SFAS 157 *Fair Value Measurements*, some of the fair value measurement guidance included in current IFRSs will remain useful.

6. If fair value measurement continues to apply to the cases where no active market exists for a transaction and its fair value is measured as if an active market exists, it is desirable that the IASB retain the guidance such as one included in IAS 39

Financial Instruments: Recognition and Measurement that deals with the case where no active market exists for a financial instrument and its fair value is measured by using the valuation technique (par. AG 77 to AG 79, see the extracts below), because such guidance will be useful for measuring fair value in a cost effective manner and ensuring a certain degree of comparability of financial statements of entities.

7. In US GAAP, such guidance as described above might be unnecessary, because US GAAP is used primarily in the U.S., where highly liquid markets exist for a wide range of goods or instruments. However, in countries other than the U.S., a considerable number of goods or instruments may be traded in markets that are not as liquid as those in the US environment, and therefore it is desirable that IFRSs, which are expected to be widely used in countries other than the U.S., include guidance for measuring fair value of products using the valuation technique, in cases where no active market exists.

Reference: Extracts from Appendix A *Application Guidance* of IAS 39 (emphasis added by ASBJ staff)

AG77 The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (ie similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

AG78 The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the

appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

AG79 In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

Issue 2. Differences between the definitions of fair value in SFAS 157 and in IFRSs

Issue 2A: Exit price measurement objective

Q3 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?

Q4 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.

Q5 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.

8. Given that a variety of items are subject to fair value measurements in current IFRSs, definition of fair value should not be limited to an exit price. If fair value is to be defined as an exit price, the items that are measured based on measurement attributes other than an exit price (such as an entry price) in current IFRSs[1] should be excluded from the scope of fair value measurement, where necessary.

9. For example, in a case where a certain financial instrument is traded in a single

[1] For example, IAS 39 (par. AG64) states that the fair value of a financial instrument at initial recognition is normally the transaction price (i.e. the entry price).

active market with no distinction between a buyer's market and a seller's market, the difference between an entry price and an exit price would normally be insignificant and they may be the same amount provided that transaction costs are excluded. In this case, using an exit price instead of an entry price as fair value at initial recognition would not have a significant effect.

10. On the other hand, if there is a distinction between a buyer's market and a seller's market, such as when a certain goods is purchased in a wholesale market and sold in a retail market, the difference between an entry price and an exit price might be significant, as it does not arise only from transaction costs. Furthermore, there are a considerable number of transactions for which no active market exists and in which you must find a seller or a buyer on your own. In these situations, it is desirable to use either an entry price or an exit price depending on the measurement objective. For example, when a transaction price is used as fair value for initial measurement of an asset, an entry price for purchasing the asset should be used for measuring its fair value from a standpoint of measuring the results of the entity's investments. In addition, an entry price should also be used for measurement in a business combination from the same standpoint.

11. Considering that the term 'fair value' is not given a single definition throughout current IFRSs, we suggest that replacing the term 'fair value' with terms that are more descriptive of the measurement attribute, such as 'current exit price' or 'current entry price' may provide more useful information to users.

Issue 2C. Transfer versus settlement of a liability

Q9 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?

Issue 6. Valuation of liabilities

Q16 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?

12. In considering the questions regarding the definition of the fair value of a liability and its measurement approach (Q9 and Q16), we would like to clarify our views that cases in which liabilities must be measured at fair value should be limited to narrow cases such as recognition of derivative liability at fair value and disclosure of financial liabilities at fair value, because, in the present market environment, no

active market generally exists for liabilities and in most cases liabilities cannot easily be transferred to a third party. The following comments on the definition of the fair value and its measurement approach are made assuming the very limited cases where a liability must be measured at fair value, not assuming the expansion of the scope of fair value measurement of a liability.

13. Regarding Q9, if a liability is to be measured at fair value, it could possibly be measured based on the consideration that would be paid if a liability is transferred. However, in practice, such a case should be very limited because, as described above, generally no active market exists for liabilities and they cannot easily be transferred to a third party.

14. Furthermore, under SFAS 157 (par. 15), fair value of a liability is measured under the assumption that the nonperformance risk relating to the liability is the same before and after its transfer. However, in practice, when you transfer a liability for which no active market exists, you should take into account the possibility that, unlike the case in which a liability is settled between a reporting entity and a creditor, the consideration that would be paid to transfer the liability may vary depending on the credit standing of the third party who will assume the liability of the reporting entity. Moreover, when considering the transaction costs to find a third party willing to assume a liability, a discount rate that makes the transfer of a liability to a third party readily possible would be a risk-free rate by which in-substance defeasance or assumption by a third party with the highest credit standing is readily available.

15. Regarding Q16, we believe that the basic approach to addressing the issue of how to deal with credit risk of a reporting entity in measuring fair value of a liability, will depend on the position on the issue of how fair value should be defined, or more specifically, whether definition of fair value should be the same for both an asset and a liability.

16. If we conclude that definition of fair value should be the same for both an asset and a liability, the fair value of a liability will reflect credit risk. However, as described above, cases that a liability should be measured at fair value are considered to be very limited.

17. In addition, although this may not be necessarily within the scope of the Discussion Paper, we are of the view that measuring fair value of a liability does not provide useful information to users of financial statements in the case other than the

limited situations described above. The reasons why we assert so are that (a) generally no active market exists for liabilities and, in most cases, liabilities cannot easily be transferred to a third party, and (b) users could be misled when fair value is used at remeasurement of a liability because, in such a case, gains and net assets would increase due to the increase in credit risk of the reporting entity.

Issue 3. Transaction price and fair value at initial recognition

Q11 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.

18. As described in our comments regarding Issue 2A, we consider that, from a standpoint of measuring the results of the entity's investments, the transaction price determined between knowledgeable, willing parties in an arm's length transaction should be used as fair value at initial recognition, in principle. Such a transaction price is considered to be consistent with the definition of fair value in IFRSs.

19. Therefore, we consider that model-based estimate of fair value rather than transaction price at initial recognition can be used only in exceptional cases where transaction price does not represent the amount determined between knowledgeable, willing parties in an arm's length transaction.

20. Furthermore, we are of the view that, accounting for a certain instrument at initial recognition should be determined taking into consideration the difference of the method of subsequent measurement applicable for that instrument. That is, when (a) other accounting standards require to remeasure an instrument (e.g. derivatives) using fair value at the end of accounting period, and to recognize the change of fair value as gains or losses, and (b) fair value of that instrument is measured based on inputs observable in a market, the difference at initial recognition between a transaction cost and fair value should be recognized as day-one gains or losses.

21. When (a) change of fair value of the instrument is recognized as gains or losses at the end of accounting period, and (b) fair value of that instrument is measured based on inputs non-observable in a market, day-one gains or losses could be recognized at initial recognition, if we follow the accounting treatment at the end of accounting period. However, in such a case, we believe that we should reconsider the meaning of measuring such instrument at fair value at the end of accounting period, considering whether fair value, measured based on inputs non-observable in a market, provides useful information to users of financial statements.

22. In addition, when the goods or instrument is not remeasured at fair value (i.e., it is measured with a measurement basis such as historical cost and change in its fair value is not recognized as gains or losses), day-one gains or losses should be deferred at initial recognition, from a standpoint of measuring the results of the entity's investments. In such a case, we believe that transaction price should be used at initial recognition. We suggest that this point should be discussed together with the issue regarding recognition of selling revenue that is being addressed in the Revenue Recognition project.

We look forward to attending the scheduled round-table meetings and thereby contributing to the deliberations for the preparation of an exposure draft on fair value measurements.

Sincerely yours,

Ikuo Nishikawa
Chairman, International Issues Standing Committee
Chairman, Accounting Standards Board of Japan