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Comment on Exposure Draft 'Fair Value Measurements' (*deadline September 7, 2004*)

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I set out below my comments on several of the issues raised by the Exposure Draft. I am also mailing to you a copy of my related study for the Institute of Chartered Accountants in England & Wales (Macve & Jackson, 1991)—further copies are available on request.

I am sending a copy of these comments to the Technical Director of the UK's ASB (a.lennard@asb.org.uk); to the Director of Technical Activities at the IASB (CommentLetters@iasb.org); and to the project manager for the Canadian Accounting Standards Board's project on *Measurement Objectives – Concepts* (peter.martin@cica.ca).

General comment

The Exposure Draft ('ED') represents a useful attempt to codify the pronouncements that deal with 'fair value' in a variety of existing FASB standards and concepts statements, and to unite them into a consistent whole applicable to both financial and non-financial assets and liabilities. However, the need for ongoing conceptual work on measurement objectives, including related revenue recognition issues, (referred to in paras. C12, C22-23, C77) means that some fundamental questions about the nature and application of fair value measurements have been left unresolved and some of the specific requirements of this proposed standard therefore seem misguided, as discussed below.

Definition of Fair Value (Issue 1)

Fair value is defined as 'the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.' A number of existing pronouncements contain an alternative definition (hereby rescinded), namely 'the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale' (e.g. SFAS133 para 540, quoted at D20 b.). However no explanation is given as to how or why the new definition differs in substance from the old, if at all, in respect of whether the fair value is to be a 'buying' (entry) price or a 'selling' (exit) price, except that there is a new requirement for items traded in dealer markets to be valued at 'bid' for long and 'ask' for short positions (both normally being entry prices for dealers but exit prices for non-dealers) (para.17)

It may be noted that certain pronouncements (including the FASB's (1999) *Preliminary Views* referred to in para.C8) have previously adopted an explicitly more restrictive definition. Thus in FASB (1999, para.47) fair value was defined as 'an estimate of the price an entity would have realized if it had sold an asset or paid if it had been relieved of a liability on the reporting date in an arm's-length exchange

motivated by normal business considerations', so for all financial instruments, both assets and liabilities, fair value was to be realization (exit) value in the 'best' market.¹ By comparison, the definition of 'fair value' adopted for financial instruments by IASB (e.g. 2004a; 2004b) is 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction', which, while it appears to accommodate the use, as appropriate, of both entry and exit market prices for assets, appears to contemplate only 'exit' prices for liabilities.²

Even though it argues that 'conceptually, fair value is a market-based measurement that is not affected by factors specific to a particular entity' (para C2), this ED necessarily acknowledges that there may be different market prices available to different enterprises, and correspondingly different measures of fair value. It proposes to resolve this divergence by requiring that entities choose as their reference market the most advantageous market to which they have immediate access (para. C45). This issue is discussed further below. However, the more fundamental issue of 'entry' versus 'exit' prices is left undiscussed and unresolved (and the definition of fair value is therefore itself necessarily left ambiguous) primarily because there is no discussion of the underlying conceptual framework of valuation which has been fully explored elsewhere in the academic and professional literature using the concept of 'deprival value' for assets (and the related concept of 'relief value' for liabilities) (e.g. Baxter, 1975, Chapter 12; AARF, 1998; ASB, 1999). It is not clear whether the Board has come to a view on these conceptual issues or whether they are still to be addressed in the conceptual phase of the project. At present the ED gives the impression that the Board is merely avoiding these issues—but until they are addressed and explained the implications of the definition of fair value and related requirements of this proposed standard are necessarily left incomplete and essentially unclear. (For further discussion see Horton & Macve, 2000.)

At this stage therefore a more appropriate definition would be: 'the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between knowledgeable, unrelated willing parties'.

Valuation Premise (Issue 4)

The ED correctly distinguishes cases where a going-concern or in-use valuation premise is generally appropriate as compared to an in-exchange valuation premise. However Example 3a of Appendix B suggests that the in-use value would be calculated by making appropriate adjustments for installation costs to the quoted price for similar used machines that are not installed. It can nevertheless be shown (e.g. Baxter, 1971; Baxter 1975, Chapter 13) that for long-lived assets (unless markets are so perfect that companies would be indifferent between replacement by new or used machines), where the optimal replacement policy in terms of cost minimisation is to buy new(er) machines, the deprival value of a used machine will generally be less than the price to buy a similar used machine, so that the proposal in Example 3a will generally overstate the value of the machine. Example 3b is correct (although it is not

¹ Footnote 24 to para. C8 of this Exposure Draft notes that the Board has 'reconsidered certain aspects of the *Preliminary Views*' but does not identify what changes have been made or why.

² However, IAS39 paras. AG64 and AG76 indicate that on initial recognition fair value is normally the transaction price (i.e. entry value)

made clear that in 3a the relevant price is the buying price while in 3b it is the selling price).

Level 1 Reference Market (Issue 6)

Three separate issues arise here:

- a) The ED proposes that the 'Level 1 reference market is the active market to which an entity has immediate access, or, if the entity has immediate access to multiple active markets with different prices, the most advantageous market, that is, the market with the price that maximizes (or minimizes) the net amount that would be received (or incurred³) in a current transaction for an asset (or liability)'. The proposal therefore refers only to the most advantageous 'exit' price, and does not consider the more fundamental issue of whether the 'entry' or 'exit' price is the relevant fair value. Under deprival value reasoning, for assets other than those intended for immediate resale without replacement, the relevant value should be based on buying price, whereas Appendix B Example 5b refers only to the best price that would be received for the asset. (A parallel argument can be applied to the entry value for liabilities—see e.g. Macve, 2003; cf. Lennard, 2003)⁴.

Does the 'most advantageous' rule nonetheless cope with this more fundamental evaluation of the relevant price? If it is interpreted (as under deprival value reasoning) as the market in which the entity will take the most advantageous action (consistent with the argument in C46 about profit-maximizing behaviour) then it can be shown (e.g. Baxter, 1975, Chapters 12 and 13) that an asset's value will be the lower of the cheapest entry price and the higher of the most advantageous exit price and the best value in use, and will therefore always be constrained to be within the range of the cheapest entry price⁵ and the most advantageous exit price, i.e. these are the relevant fair values to consider in determining the asset's value.⁶ However, although the 'most advantageous' rule is correct, the fact that this ED's explanations and examples all focus on exit prices means that users of the standard will have inadequate guidance as to how to reach a correct valuation where that should be the 'entry' fair value.

- b) Transaction costs. While Example 5b in Appendix B shows how transaction costs need to be taken into account in calculating the most advantageous market price, the ED proposes (para. 16) that transaction costs be not included in the estimate of fair value. No explanation of this is given at C26 and it is clearly inconsistent. It makes no sense to say the fair value of the asset in Example 5b is \$25 when the realizable value is only \$20. Suppose the example had been Market A price \$25 and transaction cost \$10 while Market B price was \$35 and transaction cost \$19. Now Market B is the most advantageous but clearly \$35 far exceeds the value of the asset to the entity.

³ 'Incurred' here appears to mean the amount at which an existing liability would be settled, not the amount that would be received for taking on a new liability.

⁴ Para. A22 stated that the fair value of certain liabilities is 'the price that the entity would have to pay a third party of equal credit standing to assume the liability' (an exit value). There is no discussion of whether for other liabilities entry value may sometimes be more appropriate.

⁵ Replacement cost for long-lived assets may however be lower than the current market price of an equivalent used asset in similar condition—see argument above

⁶ As noted above a parallel reasoning can be applied to liabilities.

- c) Bid-asked spreads. This is discussed below under the issues of 'Pricing in Active Dealer Markets' and 'Level 3 estimates'.

Pricing in Active Dealer Markets (Issue 7)

The ED proposes (para. 17) that bid prices shall be used for long positions and asked prices for short positions. While bid price for dealers' assets makes sense (else they would show an unrealized gain on assets held) and asked price for their short positions may be appropriate,⁷ they are both 'entry' prices and therefore inconsistent with the ED's general support for the use of exit prices.⁸ A distinction also needs to be made between dealers and non-dealers. The latter buy at asked price and sell at bid price, so for non-dealers' long positions should correspondingly normally be at asked price (i.e. replacement cost) as should also their short-positions (higher cost to fulfil).⁹ These issues are explored more fully in our study for the Institute of Chartered Accountants in England & Wales (Macve & Jackson, 1991), a copy of which is being mailed to you.

Measurement of Blocks (Issue 8)

The ED is correct to allow for blockage factors and in this respect is an improvement on the IASB's IAS39 (revised) (cf. para C76). It is also an improvement on the Board's *Preliminary Views* (FASB, 1999) and other pronouncements (para. C30). I agree that the underlying conceptual issue is that of the unit of account. But the appropriate level of aggregation is a pervasive issue for all valuations of all kinds of assets (Edey, 1974) and it would appear inevitable that either this must be left to management discretion or else certain arbitrary conventions must be adopted if the present model of accounting for 'individual' assets and liabilities is to be retained. Management explanation of the choices made in determining relevant valuation blocks should therefore be explicitly required in the disclosures (comparable to the rules for segmental reporting).

⁷ The argument here is more complex. Deprival value reasoning (and the Board's own fair value reasoning for liabilities) appears to suggest that bid price should also be the price for dealers' short positions (i.e. cost to fulfil); but this cannot be resolved without more information about the structure of the market and the competitiveness of pricing in order to determine when the dealer's spread or 'turn' is 'earned'.

⁸ As noted by Macve & Jackson (1991) p.65, regulatory requirements by securities regulators for 'long at bid and short at offer' are in fact better understood as an excessively prudent requirement for 'exit' valuation on a forced close-out basis (not a going concern basis) where the scenario envisaged is one where the market maker finds it has to sell its holdings, not to investors at its offer/asked price but to other market makers at *their* bid price; while it has to obtain securities to cover its short sales not from investors at its bid price, but from other market makers at *their* offer/asked price. Such forced transactions outside what is normally the most advantageous market are of course not consistent with this ED's definition of 'fair value'.

⁹ It may be noted that the ED's proposal to require fair values based on bid for long and asked for short positions means that, since for non-dealers these are exit rather than entry prices, they will generally give rise to unrealised losses on initial recognition for these entities. It is not clear why this is regarded as acceptable while the mirror-position for dealers is regarded as unacceptable (as is the position in relation to blocks).

Level 3 estimates (Issue 9)

Three major issues arise here:

- a) **Bid-asked spreads.** Para C52 explains that outside active dealer markets ‘other methods within the bid-asked spread should be considered (similar to other Level 3 estimates)’. However no guidance is given on how the choice between these methods should be made or whether the ED envisages it as acceptable that the method chosen should result in the fair value being closer to, or at, entry price rather than exit price.
- b) While it is important that the ‘cost’ approach (correctly described at para. 7c) is recognised as a legitimate valuation technique, the guidance given in Example 6 at Appendix B.12 on how to choose between techniques is misleading. The example suggests that the market approach be preferred because ‘the market inputs used in that approach (quoted prices for used machinery) are more relevant and reliable than those used in the cost approach (quoted prices for new machinery) because they require fewer and less subjective adjustments for differences’. While it may be that on the facts of any particular case this judgement is justified it cannot be a general guide as to which method is preferred—else why introduce the cost approach at all? And at the general level the conclusion should be the opposite. The market approach may or may not be more reliable (depending on the facts about available prices etc.) but it is certainly less relevant. As indicated above in relation to Example 3a, deprival value reasoning shows (e.g. Baxter, 1971; 1975, Chapter 13) that for long-lived assets (unless markets are so perfect that companies would be indifferent between replacement by new or used machines), where the optimal replacement policy in terms of cost minimisation is to buy new(er) machines, the deprival value of a used machine will generally be less than the price to buy a similar used machine, so that the proposal in Example 6 will generally overstate the value of the machine. (In this particular example it is unfortunately confusing that the mid-point estimate for both valuation approaches is \$45000—this will of course not generally be the case.)
- c) **Non-availability of valuation methods or availability only at excessive cost.** Para. 22 proposes that where multiple valuation approaches cannot be applied ‘the valuation technique that best approximates what an exchange price would be in the circumstances shall be used’. Similarly, Example 6 in Appendix B12 implies that this is the criterion for choosing between the valuations found by alternative techniques. However as this is the overriding objective of the fair valuation process it is not clear what specific guidance this proposal offers. Moreover, there is no clear discussion of what is to be done when no sufficiently reliable and relevant approach is available at acceptable cost. While para. 24 allows the substitution of significant entity inputs for market inputs where necessary, no example is given in Appendix B for this situation and there is no guidance offered as to when these inputs must be regarded as so unreliable that ‘fair value’ simply cannot be estimated. Paras. C19-C23 merely point out that the ED does not alter the current GAAP on ‘practicability exceptions’ noting that issues about reliability of fair value measurements are to be addressed more broadly in the conceptual phase of the project. In the wake of Enron this is a major lacuna in this ED.

Other issues (Issue 13)

I agree that the Board needs to consider issues relating to the relevance and reliability of fair value measures before deciding how far to extend fair value recognition to other assets and liabilities for which it is not currently required. However, even more important is first to resolve, in collaboration with standard setters internationally, the more fundamental conceptual issues about measurement and valuation generally (para.C77). This requires a full consideration of 'deprival value' reasoning (e.g. AARF 1998). Such consideration will necessarily involve issues of the unit of account.

However, an even more important issue is that of the impact of valuation approaches, both in respect of initial recognition and subsequent remeasurement, on performance measurement and revenue recognition (e.g. para. C23), and this needs to be addressed as the first priority. (For further discussion see Horton & Macve, 2000.)

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