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Re: *EFRAG draft comment letter on Exposure Draft Fair Value Measurement*

Dear Madam/Sir,

The OIC welcomes the IASB's project to provide a new definition of fair value and to improve the guidance for its measurement. The OIC approves of the convergence project by the IASB and the FASB on this issue.

However, while we are in broad agreement with the framework for the measurement of fair value as regards financial assets/liabilities, we have serious doubts as to whether it can be usefully applied to non-financial elements.
Moreover, we believe that any valuation element present in this Exposure Draft that may concern assets or liabilities related to insurance contracts should be evaluated in relation to with the principles being determined under Phase II of IFRS 4.

Our main concerns are:

- we do not agree with applying fair value as so defined to non-financial items; for such elements, the indications given in the ED appear to be particularly complex and in some cases so lacking in clarity as to make their application difficult;
- in general, we believe that the correct criterion for the measurement of liabilities, be they financial or non-financial, is the fulfilment value, that is, the sacrifice (cash outflow) that the entity will have to make in order to meet its obligations;
- we do not agree with the introduction of the concepts of highest and best use and of in-use and in-exchange premises for non-financial assets;

- we do not believe it to be correct that non-performance risk should be taken into account in the fair value measurement of a financial liability.

Here below are our comments on the ED questions.

Question 1—The exposure draft proposes defining *fair value* as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when *fair value* is used in IFRSs.

Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

The new definition of fair value proposed in the ED, while using different wording from the current definition, expresses the same concept, that is, that fair value is a market-based measurement in a transaction between unrelated parties. In the definition of fair value, the ED refers to a concept of the exit price of an asset or liability, making reference to future cash inflows and outflows connected to the asset or liability from the standpoint of the market participants at the date of measurement.

Given the proposed new definition, the OIC has serious doubts as to whether valuing liabilities on the basis of fair value, as defined in the ED, would, in most cases, provide useful information to the readers of financial statements. The OIC believes that, in general, the correct criterion for measuring liabilities (financial and non-financial) is the fulfilment value, that is, the sacrifice (cash outflow) that the entity will have to make in order to meet its obligations. Making reference to theoretical market prices does not represent, in most cases, what actually happens, that is the actual cash outflow incurred by the entity. In any case, while recognizing that fair value measurement of some liabilities, above all financial ones, may in some cases improve the overall picture provided by financial statements, the OIC does not believe that the determination of fair value should be made by taking into consideration own credit risk (see response to Question 8).

We agree with EFRAG that, with particular reference to non-financial assets/liabilities, the proposed definition is unacceptable for two main reasons.

The first concerns the fact that the definition itself and the related guidance sometimes appear to be lacking in clarity, difficult to understand and apply, and such as to cause

confusion among operators and result in their inconsistent application (e.g. the indications provided for highest and best use).
The second lies in the fact that, for such elements, we are not convinced that the application of fair value will provide information that is "more decision useful" than the information that would be obtained by applying other valuation criteria based on current value. Above all with regard to non-financial liabilities, we believe that valuations based on entity-specific factors would be more useful than a generic reference to the market participants.

Furthermore, it is worth noting that, for most non-financial assets and liabilities, there are no active markets and, hence, it would be difficult to apply the fair value framework.

Some specific comments are necessary concerning the insurance sector. It is necessary to point out that insurance liabilities cannot be measured on a "transfer value" basis, there being no secondary market to refer to, and that the fair value concept present in the IAS – IFRS can also be interpreted differently from the transfer value. It is an economic valuation of the insurance liability that most enables the determining of a correct quantification of the liabilities, but it is its very complexity that has made necessary the drawing up of a specific accounting principle, which is still the subject of debate. Furthermore, it is necessary to point out that for the quantification of assets, also financial assets, relating to insurance liabilities, the core principle in valuation must be that of ensuring a consistent valuation between the asset and liability elements in order to avoid significant mismatchings with potential negative impacts not only in terms of clarity in the financial statements but also for the insured parties. Thus, it is possible that, given the current corpus of IAS – IFRS principles and the valuation of reserves in accordance with local GAAPs, some asset elements, even though of a financial nature, should follow a valuation model other than that of fair value.

Question 2—In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts:
(a) In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 Share-based Payment and reacquired rights in IFRS 3 Business Combinations) (see paragraph BC29 of the Basis for Conclusions).
(b) The third context is the requirement in paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement that the *fair value*of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.
Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

We agree with the exceptions proposed in the ED. However, in view of the considerations set out in the response to Question 1, we share the EFRAG's view that it is appropriate to exclude all elements of a non-financial nature from the application of the principle.

Question 3—The exposure draft proposes that a *fair value* measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions). Is this approach appropriate? Why or why not?

With agree with the proposal in the ED, that is that the fair value valuation must relate to the most advantageous market to which the entity has access. We also agree with the assumption that the market in which the entity usually operates is the most advantageous market. These proposals seem to be referred mainly to transactions in financial instruments.
On the contrary, they do not seem appropriate to assess the fair value of non financial assets and liabilities. This because, in theory, the most advantageous market for the entity could not be available for logistic reasons and business strategy. Furthermore, entities have not always the same information and that could compromise the comparability or produce discretionary results difficult to verify. Maybe, for non financial elements, it would be useful to clarify that "the most advantageous" market should be observable and that actually the entity operates in it.

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 description proposed in the ED regarding market participants.

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 concepts of highest and best use and valuation premise should not be applied either to financial assets or to liabilities in general, for the reasons given in the ED.

However, we share the EFRAG significant concerns regarding the application of the concepts of highest and best use and of "in-use and in-exchange premises" to non-financial assets. Indeed, for such elements, we believe that the entity-specific values based on the way in which the entity intends to utilize the asset provide the best possible information for users on future financial flows relating to the asset itself.

Furthermore, we believe that the guidance given in the ED regarding such concepts could cause confusion (as well as arbitrariness) among operators in its application in practice, with evident negative effects on the quality of the accounting information. One of the inconsistencies that emerges from a reading of the ED lies in the fact that the ED requires, on the one hand, the identification of the most advantageous market that the entity can access (thus, referring to entity-specific valuations) and, on the other hand, speaks of the use that the market participants may make of the asset (thus, referring to elements specific to the market participants). Moreover, with regard to these new concepts, in our opinion, there is a lack of exhaustive examples covering their application in practice.

Notwithstanding the doubts expressed, should the indications given in the ED be put into effect, we do agree with the assumption that, unless there is evidence to the contrary, the current use of the asset by the entity does represent its highest and best use.

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?

The OIC does not consider the operational guidance provided in the ED to be appropriate and sufficient. Indeed, we believe that the introduction of measures that are so important and of such difficult application (given the arbitrariness that is left to the preparers) warrants examples that cover an especially varied range of cases, as opposed to just the single one provided in the ED. This would be necessary in order to clarify the general principles underlying the concepts that are to be introduced.

Question 7 - The exposure draft proposes that:
(a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).
(b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).
(c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).
Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

As clarified earlier, the OIC believes that, in general, the proper criterion for measuring liabilities (financial and non-financial) is the fulfilment value, that is, the sacrifice (cash

outflow) that the entity will have to make in order to meet its obligations. Making reference to theoretical market prices does not represent, in most cases, what actually happens, that is the actual cash outflow incurred by the entity. The OIC confirms this position both with regard to IAS 37 (currently under review) and for financial liabilities.

We do not agree with the proposal in the ED whereby, as EFRAG notes, in the event that a liability has a corresponding asset, the fair value of the liability is estimated as being equal to the fair value of the corresponding asset, as this seems to conflict with the framework on fair value. Indeed, we believe that market participants that can hold the entity's liability as an asset are generally different from market participants that could assume the liability (transfer notion of the liability); these market participants could make different valuations concerning the fair value of the asset/liability.

Question 8 - The exposure draft proposes that:
(a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfil the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).
(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?

The OIC does not believe that the fair value measurement of a liability should take into account the non-performance risk, by modifying (increasing or reducing) the amount at which the liability is carried in the accounts and registering a profit/loss. As more fully described in our comment letter on the DP of the IASB "Credit Risk in Liability Measurement", we are convinced that such a treatment would not introduce significant information into the financial statements and, indeed, might make the financial statements less understandable to users.

Question 9 - The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions). Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

We consider correct the treatment outlined in the ED with regard to day one gains or losses. In general, their treatment should be governed by the individual international accounting principles.

However, it should be noted that the accounting treatment of day one gains and losses as indicated in the Exposure Draft may not be consistent with the management of assets and liabilities by insurance entities. In this regard, we would point out that any day one gains should be entered or not in the accounts in compliance with the business model and existing accounting rules concerning the asset or liability in question and with the accounting standards on the basis of which said asset or liability has been recognized (IFRS 4).

Question 10 - The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples). Is this proposed guidance appropriate and sufficient? Why or why not?

We agree with the guidance provided in the ED on the valuation techniques proposed, which are in widespread use and well known.

With regard to the guidance provided on markets that are no longer active, we believe that the reference to the active market is too generic in some cases; for example in all those cases in which, although there is an active market, there are, within the market, particularly illiquid securities.

Furthermore, there is an inconsistency between the definition of an active market (par. 48) and the listing of factors that could indicate that a market is no longer active (par. B5). The definition of an active market is based on only some of these factors (volume, frequency) while the other factors given in paragraph B5 should not be relevant for identifying an active market. This could lead to a non-consistent application of the guidance.

Question 11 - The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions). Are these proposals appropriate? Why or why not?

We agree as to the information required by the ED, except for that pertaining to assets "that are not employed" utilizing their "highest and best use".

Question 12 - The exposure draft differs from Statement of Financial Accounting Standards No. 157 Fair value Measurements (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157. Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

We believe that the differences between the ED and SFAS 157 constitute improvements in the guidance for determining fair value, as they clarify the application of the principle. As already pointed out, we do not agree with the proposed guidance regarding the concepts of highest and best use of a non-financial asset.

Question 13 - Do you have any other comments on the proposals in the exposure draft?

No, we have no further comments to make.

Yours sincerely,
Angelo Casò

(OIC Chairman)