



**ASSOCIATION ACTUARIELLE INTERNATIONALE  
INTERNATIONAL ACTUARIAL ASSOCIATION**

September 28, 2009

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir

**Re: IAA comments on the IASB Exposure Draft on *Fair Value Measurement***

In response to the request for comments on the Exposure Draft on *Fair Value Measurement*, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by a task force of the Committee on Insurance Accounting. If, upon reading these comments, you identify any points that you wish to pursue, please do not hesitate to contact the chairperson of that Committee, Sam Gutterman, or any of the other members of the Committee. The IAA will be pleased to develop these ideas further with you.

Yours sincerely

Yves Guérard  
Secretary General

[Attachment](#): IAA comments

**A Commentary on the  
EXPOSURE DRAFT ON FAIR VALUE MEASUREMENT  
Released by the International Accounting Standards Board: May 2009**

**International Actuarial Association**

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty-two Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The Full Member associations of the IAA are listed in an Appendix to this statement. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries. The IAA appreciates the opportunity to provide comments on this IASB exposure draft.

**IAA Due Process**

These comments have been prepared by a task force of the Committee on Insurance Accounting. Our comments are written from the perspective of actuaries involved in financial reporting for insurers around the world, with an emphasis on measurement of insurance liabilities and reinsurance assets. Statements in this letter with respect to industry practices reflect the collective experience of the actuaries who participated in the preparation of this comment letter, which we believe represents an accurate and fairly comprehensive view of the insurance industry globally. The members of the task force and committee are listed in an Appendix to this statement. It has also been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA’s official web site.

**GENERAL COMMENTS**

*Support for a standard on fair value measurement*

We support the issuance of general guidance on fair value measurements. It will provide guidance in a single source and, thereby, should improve compliance. It should also facilitate greater consistency of measurement across financial instruments and other assets and liabilities where a fair value measure is required. We also support convergence of fair value measurement guidance worldwide and, to this end, we hope that the FASB will consider revision of the guidance provided in SFAS 157 to eliminate any differences, or better, that the IASB and the FASB would work together to move toward consistent, clear and high quality guidance worldwide.

*Definition and meaning of “fair value”*

We are concerned that, while the definition of fair value is reasonable, the associated guidance may place too much reliance on observed transaction prices. Such reliance is appropriate when the transaction is at arms’ length between peers in an orderly transaction taking place in a deep liquid market, but the need for fair value, as distinct from market value, arises primarily in contexts where these conditions – arms’ length, between peers, orderly transactions, deep and liquid markets – are not present. In our view, when measuring value, consideration should be

given to the extent to which these conditions are met and a greater emphasis should be ascribed to what the price would be if they were met.

#### *Current applications of fair value measurement by insurers*

A significant amount of our experience relates to the financial reporting of liabilities for insurance contracts and investment contracts issued by insurers. Current application of fair value measurement to insurance contracts includes business combinations and portfolio transfers. Other applications involve derivatives embedded in insurance contracts that must be separated and measured at fair value through profit and loss under guidance found in IFRS 4. In addition, the application of certain aspects of fair value measurement may be used in the measurement of insurance contract liabilities if the Board decides that those characteristics are similar or should be taken from the measurement objective of fair value (e.g., in the determination of discount rates), even if its overall measurement objective is not fair value, or if the measurement of insurance contract liabilities in a business combination is determined to require fair value measurement. Even if the anticipated insurance standard is not a fair value measurement, the Board's decisions with regard to fair value measurements may have significant implications for the insurance contracts standard, as the adopted measurement attribute will likely be similar to fair value measurement in some respects.

The IAA has always taken the position that assets and liabilities should be measured on consistent bases, as close as possible to their underlying economic values. (Note that "consistent" does not mean "identical".) In this regard we note the interaction between decisions made on the use of fair values in the measurement of assets held by insurers and the decisions to be made in the measurement of insurance contract liabilities.

Our specific comments on the proposed standard are found below in our responses to the specific questions raised.

### **Comments regarding Specific Exposure Draft 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?*

**IAA Comment:** The definition is appropriate, since it succinctly conveys the overarching characteristic of the measurement attribute.

While we agree with the definition as stated, we believe that more attention should be paid to the characteristics of a market in which a transaction would occur. While the immediate problem with fair value in the current Global Financial Crisis has been measurement when assets or liabilities are illiquid and where a distressed market exists in which most transactions are at "fire sale" prices, the conditions that led up to it involved an extended period during which prices were unreasonably high – partly because they were based on an unrealistic assessment of default

risks, but more generally because the market was in “bull” or “bubble” mode – and focussed more on what an instrument might be sold for tomorrow than on the associated long-term cash flows.

In our view, an appropriate reference market is one in which prices bear a reasonable relationship, in the context of current economic conditions, to the cash flows that might reasonably be expected to emerge if an asset or liability is held for its natural life, whether by the reporting entity or by a hypothetical purchaser. This is closer to the “in use” than to the “in exchange” valuation premise. Since markets appear seldom to be in this state, with prices driven more by speculation than by longer-term considerations, we believe that it is inappropriate to assume, without examination, that even a deep and liquid market provides the appropriate benchmarks or inputs for a fair value that is based on a valuation technique. It may, nonetheless, be possible to conclude upon examination that prices in a particular market are a reasonable indication of 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?*

**IAA Comment:** We do not have a comment on the first two contexts. We agree with the Exposure Draft (ED) with respect to the third context; there should not be a constraint on the measurement of fair value that creates the possibility that the reported amount would differ from the amount that would be observed in a transaction that meets the fair value criteria.

While it is important to reflect a demand feature in fair value measurement, this need not imply that it should be assumed that all counterparties will exercise this right at the earliest available advantageous opportunity. (That might not even maximize the advantage inherent in the option, since there may be the possibility of even more favourable conditions later.) Not only can the use of such an assumption introduce a conservative bias into the valuation of many liabilities, it would not normally be made by a hypothetical purchaser of such liabilities. Rather, a purchaser would consider the likely future behaviour of counterparties in light of current and potential future economic conditions and would make a judgment as to the extent to which it is appropriate to allow for the exercise of the demand feature. Further, the occurrence of a transaction may have an effect on the continuation of contracts with surrender options, as owners of contracts may not wish to continue the contract with the acquiring entity.

For example, the fair value of an insurance contract may, in fact, be less than the cash surrender value, because the fair value is not an amount that is known or necessarily relevant to the decision-making process of the policyholder. Furthermore, policyholders are inclined to retain their insurance contracts if the need for the insurance continues to exist and the price of a new contract is not favourable or it may involve renewal underwriting that could place restrictions on the coverage. Because prices reflect acquisition costs as well as expected cash flows and are influenced by such factors as increasing age in the case of life insurance, the price of a corresponding new contract is not necessarily favourable even if the fair value of the contract is less than its cash surrender value. In the case of insurance contracts it is especially difficult to generalize, because the fair value calculation will not consider the individual circumstances of each customer and the risks to which the insurer is subjected.

Therefore, we believe that, regardless of its merits as an element of measurement, a “demand floor” should not be a feature of fair value in general, but might be a consequence of specific circumstances. At the same time, we acknowledge that practitioners will need to consider expected counter-party behaviour, whether or not the estimated value is below the amount payable on demand. We wonder if the Board’s view in that regard is that the behaviour observed in the past by the reporting entity may differ from what other market participants might assume in pricing a transfer. We also note that the margin for the uncertainty related to expected contract termination rates will tend to move the estimates in the direction of the deposit floor, suggesting that a value that is significantly below the deposit floor should cause the reporting entity to re-examine assumptions and margins of the contract.

We believe that the Board should remove the unconditional requirement that embedded derivatives be separated and measured at fair value through profit and loss if the measurement attribute of the asset or liability is not fair value. We refer also to the current proposal for the revision of IAS 39, that the separate valuation of an embedded derivative for a hybrid contract with a financial host should not be required. In any case, we expect that the separation will not be necessary for insurance contracts once the Board decides upon a measurement attribute for insurance contracts. The decision to require separation should be made for measurement attributes as they are adopted and should no longer be a part of guidance for measurement of financial instruments.

**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?*

**IAA Comment:** No, we do not believe that this approach is appropriate. The Board sees conceptual advantages to assuming the transfer of liabilities in the most advantageous rather than the principal market. We are not convinced of the advantages of this assumption, nor that the benefits outweigh the practical issues. For example, when prices are not observable, an entity will be more familiar with its principal market and, thus be better able to make reliable estimates of the transfer price.

The ED states that:

- “An entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market. The market in which the entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market.” (paragraph 10); and
- “In the absence of evidence to the contrary, an entity may assume that the *principal market* for the asset or liability is the most advantageous market, provided that the entity can access the principal market.” (paragraph 11)

We conclude that the Board believes that the situation where principal markets are not the most advantageous markets will be unusual. We agree and, therefore, we believe the reference to the most advantageous market is not needed. We also find that the requirement of even a less-than-exhaustive search places entities in an uncertain position.

We believe the objective of fair value measurement is met if entities report on prices in the principal market for which observable prices for the instrument/contract are available and that no additional useful information is gained by benchmarking to the most advantageous market. The most advantageous market, when different from the principal market, is often the short-lived consequence of special circumstances and is neither deep nor liquid. The use of a price in the most advantageous market, which may be transitory in nature, introduces additional volatility in measurement that may, in fact, detract from the decision-usefulness of the information provided. It is also more likely that there will be a greater need to use valuation techniques, even when prices are observable in the principal market. If trading in alternative markets is thin, the choice of the most advantageous of these may also require a subjective decision and the need to use a valuation technique.

The footnote to paragraph 11 distinguishes between “access” to a market and the ability to actually execute the transaction, due to a restriction on the asset or liability. We believe that this redefinition of “access” is inappropriate. A restriction on an asset or liability can change the price and value of that asset or liability. If an entity cannot sell or transfer an item in a market because of a restriction, it does not have “access” to that market. We therefore believe that this footnote, which essentially redefines the term “access”, should be removed.

**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?*

**IAA Comment:** Yes. We find the description of market participants to be consistent with the definition of fair value. It adequately describes a market participant that is involved in an orderly transaction.

**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?*

**IAA Comment:** Although we understand the reasons for the premise of highest and best use, we are not yet convinced that it is appropriate. We suggest that the Board consider providing clarification of the implications to the reporting entity of a fair value at highest and best use.

Using the example in paragraph 19, we wonder if a trademark that is acquired and then retired has value or is impaired because it is no longer currently in use. If not used, its value would be eroded in the market place. If not measured at fair value after the acquisition, should it be impaired as an expense when acquired or should it be impaired as an expense over time as it loses its attractiveness? We note that the entity’s trademark likely increases in value if a competing trademark is acquired and then retired. If the entity’s trademark is not recognized or is not measured at fair value, then the expense associated with the impairment of the acquired trademark would not be offset by the increase in value of the entity’s trademark. Hence, in this case, the benefits of acquiring the trademark would be obscured.

Another situation that might arise is where the highest and best use of one asset, viewed in isolation, may require degradation of the entity’s assets taken as a whole. For example, a property developer may choose to dedicate a block as parkland because this will increase what it can get for the surrounding blocks by more than the price that it could otherwise get for that block. At the very least, the “value in transfer” should reflect the cost of making alternative arrangements, such as the cost of moving operations to another site.

We believe that the concept is not applicable to financial instruments, given that IAS 39 does not allow for consideration of blockage or other factors. We also believe that the concept might be related to unit of account and, hence, it may be applicable to some liabilities, e.g., to insurance contracts. For example, the highest and best use of an insurance contract by the issuer is within a portfolio of contracts. Hence, if the unit of account for insurance contracts is the individual contract, its measurement is most relevant and reliable if it is considered in use with other contracts. But if the unit of account is a portfolio of homogeneous contracts, the best use of it may be in the largest portfolio of such contracts.

We believe that this is an example of where treatment of unit of account may be unclear and should be addressed in a principle-based manner, as current guidance is unclear where there is no active market. If instruments or contracts are measured on the basis of a portfolio, then the appropriate unit of account should be a portfolio.

Here, as in other specialised cases, the number of entities able to make best use of this concept might be very small. If best use is required, it should be the best use that is generally available to a reasonable number of market participants. It should exclude uses that are only possible in special circumstances. If, for example, a certain machine is intended to make something in general use but has also been used to make, at great profit, a unique item for which there is very limited demand, the fair value of the machine should be predicated on its normal 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 (i.e., their incremental value). The entity should recognize 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?*

**IAA Comment:** The guidance regarding the value of assets at their current use is not sufficient. First, it is not clear to us what the resulting measurement attribute represents. Also, we are not convinced that what is given is useful in all cases. It is not clear from the proposed guidance what the incremental difference represents and how its movement should be presented in profit and loss. The need to calculate and disclose the difference should be assessed in connection with the development or modification of the accounting for the specific assets.

If the Board decides to require such dual measurements, then we recommend that it establish a measurement attribute, such as a value in use or “fulfilment value” similar to the value as described in paragraph 4(c)(a) (“the value to the entity of not having to fulfil the obligation”) or the value as found in Agenda Paper 8A of the July meeting regarding the revision of IAS 37 (but for both assets and liabilities) that would reflect the use or cost of the item to the entity holding it for the entire period during which the obligation exists or over its useful life, but measured considering a market perspective.

**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 (e.g. 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?*

**IAA Comment:** We agree that, according to the definition, the fair value of a liability is its value if it were to be transferred on the date of measurement. However, we refer to our response to Question 6 regarding related guidance about how the price in a transfer is most suitably determined.

The use of an observed price in a transaction involving financial assets as the fair value of the issuer's liability presumes that market participants who buy and sell the financial instruments as assets consider the same factors as market participants in a transfer of the liability. Without support for this presumption demonstrated by actual proof of its occurrence, this requirement should not be imposed.

We believe that, in the context of uncertain outcomes, the concept of mirror accounting is fundamentally unsound. As a general proposition, the value of an uncertain cash flow stream, viewed as an asset, is the expected present value of the cash flow stream, **minus** a margin reflecting the economic value of the uncertainty. Viewed as a liability, the value is the expected present value of the cash flow stream, **plus** a margin reflecting the economic value of the uncertainty.

In addition, there is seldom a deep and liquid market for liabilities from which observable prices may be obtained.

In a deep and liquid market for the corresponding asset, buyers and sellers reach an agreed upon price, most probably based on differing views as to the expected present value of the cash flows, perhaps based on different individual abilities to influence, or to make use of, the cash flows. It is only appropriate for an entity to adopt that compromise value as the fair value of its liability if it can, as a legal and practical matter, actually transact its liability in that market. Otherwise, the value of the liability should be based on the three building blocks, including a margin reflecting the economic value of the uncertainty that it cannot trade away. This inability to trade is a feature that is present in the liability, reported by the entity that bears the obligation, as envisioned in part (b) of this question. As such, since a restriction is more common than the third party credit enhancement of the corresponding asset envisioned in paragraph 27 of the draft IFRS, it should be mentioned in that paragraph.

In the absence of a deep and liquid market for either asset or liability, there is no market compromise. In fact, a possible reason for the non-existence of the market could be that such a compromise cannot be found, the items are not sufficiently homogeneous to be traded actively or there is no legal possibility to trade them. It is probable that any valuation technique based on cash flows will result in different asset and liability values, reflecting the reluctance of the transferee to take on the uncertainty. Any compromises reached in actual transactions are likely to be the product of factors unique to those circumstances.

The approach proposed for liabilities where there is no corresponding asset is appropriate and should be applied for all liabilities where the liability holder does not have unrestricted access to

a deep and liquid market. Nonetheless, it may be appropriate to use the observed price as a benchmark value to help assess the reasonableness of the value that results from the use of a valuation technique.

**Question 8.** *The exposure draft proposes that:*

- (a) *the fair value of a liability reflects non-performance risk, i.e. 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?*

**IAA Comment:** We have provided our thoughts on the inclusion of credit risk in the measurement of liabilities in our response to the Board's Discussion Paper on *Credit Risk in Liability Measurement*. Although conceptually appropriate in theory, we believe that the guidance should not require the entity to reflect non-performance risk in the measurement of a liability. The principle should be that the entity considers all inputs that market participants consider. For example, non-performance risk is seldom, if ever, an explicit variable in the pricing of a transaction involving the transfer of insurance liabilities. It may, however, be reflected implicitly in the margin (e.g., if a cost-of-capital approach is used to set margins) or indirectly in other assumptions, such as the assumption regarding voluntary termination of a contract where that termination may be affected by the extent of likely non-performance.

There is also a danger that a requirement that the entity reflect non-performance risk could be interpreted as requiring an explicit allowance and risk double-counting if the valuation approach adopted already incorporates an implicit allowance for this risk.

We recommend that this section instead should articulate the broader principle or, perhaps, should indicate in application guidance that preparers should not overlook the effects of non-performance risk on the measurement of liabilities. We recommend the use of the wording in paragraph C3 of the Application Guidance:

...the following general principles govern the application of any present value technique used to estimate fair value:

- (a) Cash flows and discount rates shall reflect assumptions that market participants would use when pricing the asset or liability.

This principle can be generalized to cover the incorporation of non-performance risk into the measurement of liabilities.

**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?*

**IAA Comment:** We agree that the standard should not prescribe the treatment of the difference between the estimated fair value and the transaction price for assets or liabilities that have observable prices.

While we believe that there should seldom be a gain or loss when the fair value is dependent on level 3 inputs, we do not believe that there should be an outright prohibition in the context of fair value measurement. A more appropriate approach would be a rebuttable presumption that there is no initial profit or loss, tempered according to the strength of the evidence that such a gain or loss does exist or is expected.

Having said this, we believe that there are contexts in which there should be either no gain or loss at inception, or no gain but a possibility of a loss. This, however, is not a feature of fair value and should be implemented in terms of either a different measurement basis or an explicit adjustment to fair value in the applicable IFRSs.

We do not agree that there should be a different approach when the fair value estimate uses a valuation technique for which inputs depend only on observable market data. We are concerned that this overlooks the possibility of modelling error (e.g., unintentional omission of an input) or that the inputs, while observable, are not necessarily the most relevant for the asset or liability, i.e., they may be the most convenient because they are observable.

We suggest that the Board consider clarifying what happens after initial measurement. The reference in paragraph 39 to periodic recalibration of the valuation technique suggests that the Board expects that models will have a calibrating variable (such as basis points in a discount rate) that will not change absent evidence that a change is appropriate. If this is the case, it would be useful to include clarification of what is required, either in the final standard or in the application guidance. We would like specifically to draw the attention of the Board to its current argument in the Revenue Recognition Project that an approach that allows the current estimate to fluctuate, but keeps the calibrating margin locked-in, does not comply with an economic measurement attribute.

**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?*

**IAA Comment:** We believe the proposed guidance is generally appropriate and sufficient, subject to our comments above. When a market is no longer active, the measurement of the asset or liability changes to a different level in the fair value hierarchy, a change that will be disclosed. We believe that there is no need for separate or different guidance for markets that are no longer active. However, the initial measurement under the new (lower) level in the fair value hierarchy

should be made applying the same principles as in initial measurement at such a level, with the last reported value as substitute for the transaction price; i.e., if a calibration would be required at initial measurement, it should also apply here.

In relation to disorderly markets or where prices of observed transactions are not relevant or reliable, we believe that a much broader approach is needed. The criteria set out in paragraph B5 are descriptive of individual transactions that are inconsistent with more general market conditions or of a market that is in crisis. They do not address the more common situation of a depressed or overheated market.

In any market, there may be two principal categories of participants that can be broadly categorised as traders (speculators) and investors. Traders are mainly interested in buying and selling – the “in exchange” perspective. Investors are mainly interested in the asset or liability *per se* – the “in use” perspective. These different approaches can result in different perceptions of value.

In an orderly market, buyers and sellers, including both traders and investors, operate efficiently and prices are broadly compatible with risk-adjusted expected present values of the cash flows of assets and liabilities over their natural life.

In contrast, in a depressed market, investors are reluctant to sell, so prices are set largely by traders. Investors who do sell usually do so under some degree of duress. Traders can also be aware that current prices are depressed and trades are likely to be motivated either by duress or by an expected opportunity for a better deal – typically courtesy of other parties’ duress. As a result, market activity is likely to be low, but not as low as in the depths of a market crisis.

In an overheated market, investors are reluctant to buy, so again prices are largely set by traders. Investors who do buy usually have some form of pressing need to do so. Knowledgeable traders may also be aware that current prices are overheated but are likely to ignore this, in the belief that they can identify the top of the market before it is too late.

While prices set largely by traders may be an appropriate basis for valuing trading assets, they are less appropriate for assets held for investment. The biggest associated problem relates to the relative behaviour of asset and liability values in the context of the entity’s business model. Liabilities are seldom traded and are very seldom held for trading purposes. In many cases, the complementary asset is also seldom traded, so the only valuation approach available is the risk-adjusted expected present value of cash flows. Such valuations do not readily reflect the less rational aspects of market behaviour. If a fair value is to provide a proper basis for comparison of asset and liability values, the fair values of assets need also to relate properly to the risk-adjusted expected present value of cash flows.

For this reason, we believe that fair value should be primarily determined through valuation techniques that focus on cash flows. Actual market prices can, in a market in broad equilibrium, provide a useful proxy, but should not be accorded the absolute primacy implied by the fair value hierarchy, as set out in paragraph 43 of the Exposure Draft. In other words, we believe that fair values should not be defined as market values *per se*.

If, as could well be the case with assets held for trading, it is considered necessary to retain the emphasis on market prices, it would be preferable to refer to *market value*, rather than impose an unnatural meaning on the word *fair*.

**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?*

**IAA Comment:** We believe that the proposed disclosure requirements are appropriate. We would add the requirement that the entity disclose not only what the inputs are but also how they were developed in those instances where they are not observable. This is similar to the requirement that insurers disclose the process for setting assumptions in the measurement of their liabilities.

**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?*

**IAA Comment:** We agree, except for two points:

1. We do not agree that reference to the most advantageous market is an improvement on the use of the principal market. We have given our reasons in our response to Question 3.
2. We do not agree that the measurement of a liability should be the same as the measurement of the corresponding asset of the counterparty. We have given our reasons in our response to Question 7.

Since we support convergence of fair value measurement guidance worldwide and, to this end, we hope that any differences from the guidance provided in SFAS 157 would be considered for elimination by the FASB in order to move toward consistent, clear and high quality guidance worldwide.

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

**IAA Comments:**

Paragraph 41 of the Exposure Draft, in effect, defines *observable* and *unobservable* in terms of market observation only. This is an undesirable departure from the natural meaning of these phrases. A much clearer terminology is *market inputs* and *non-market inputs*.

The last sentence of paragraph 50 of the Exposure Draft appears to read as a statement of fact, rather than of guidance. It would be clearer if it were re-worded as, for example, “However, if the quoted price is adjusted for new information, the resulting measurement is no longer based solely on level 1 inputs and falls lower in the fair value hierarchy.”

Paragraph C13 of the Exposure Draft refers to portfolio theory, without reference to the fact that the relevant conclusions from that theory depend on assumptions that are never achieved in the real world. In particular, diversifiable risk can only be (economically) fully eliminated in a perfect market that:

- comprises an infinite number of finite risks; and
- has no transaction costs.

Both of these requirements are violated in real markets.

In practice, some risks (e.g., a natural disaster such as a volcanic eruption that might be of global proportions) are large enough that the minimum residual risk (the square root of the ratio of individual to total exposure) is material. Even where this is close to zero, it does not make economic sense to pay more in transaction costs than the resulting reduction in the value of risk. While transaction costs in some markets are low, there are also assets and liabilities where the transaction costs are very high.

A further basis of portfolio theory is the efficient market hypothesis. This, too, is demonstrably false, as illustrated by the ability of markets to rise and fall substantially on the basis of suppositions that are not factual and by the need for restrictions on insider trading.

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