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Mr. Steve Ong
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Dear Steve,

IASB Exposure Draft ED/2009/5 Fair Value Measurement ("the Exposure Draft")

I refer to your separate letters dated 18 June 2009 to our Mr. Paul Chow and Mr. Archie Tsim on the above which have been passed to me for my attention.

We have reviewed the Exposure Draft and our comments for your consideration are set out below.

General

The objective of the Exposure Draft is to provide a single source of guidance that explains how to measure fair value. We support the IASB's decision to issue guidance which should reduce complexity and improve consistency in the application of fair value measurements.

The objective of financial reporting is to provide information useful to users of financial statements in making economic decisions. We agree that fair value information is useful as it reflects current market conditions, however, how it is recognised, presented or disclosed is the fundamental issue.

The recent financial crisis highlighted and intensified the debate on fair value measurements and opponents of fair value accounting, particularly preparers, argue that fair value accounting should be suspended where there is a distressed market. We note that such arguments are perhaps inconsistent in that when a market is overly buoyant it can also be regarded as distressed or abnormal as the prices are unrealistic and do not reflect the true underlying long term worth of the relevant assets.

We believe that the most controversial issue on fair value accounting and measurement is its application. We believe conceptual issues of what and why only certain assets and liabilities should be stated at fair values and how the gains / losses are recognised and disclosed have not been fully discussed and we would suggest that this conceptual framework exercise be considered as a matter of urgency.

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The Exposure Draft is based on FASB SFAS No. 157 *"Fair Value Measurements"*. We however note that the IASB's views and direction are not always entirely consistent with that of US GAAP and believe the IASB should consider whether it is appropriate to adopt US GAAP guidance before considering the fundamental conceptual basis for fair value accounting. We set out comments regarding certain key areas in the paragraphs below.

Fundamental conceptual rethink required

The Exposure Draft does not address *"when"* and *"why"* fair value measurements should be adopted and this would have been helpful to provide useful background context in applying the guidance.

The current conceptual Framework neither provides any analysis of the strengthens and weaknesses of fair value measurement bases nor does it provide any guidance in determining when and how to apply a particular measurement basis. The IASB should include a discussion of the objective of fair value measurements and explain why some, but not all, assets and liabilities should be carried at fair value.

We suggest that the conceptual Framework should clearly articulate the trade-off or relative importance placed on the qualitative characteristics of financial statements, including understandability, relevance, reliability, faithful representation and comparability. This would assist preparers to justify how well the different measurement bases satisfy these characteristics so as to provide useful financial information to users. In particular, we are concerned that the reliability characteristic is not given the adequate weighting it deserves.

Fair value measurements which are entirely based on hypothetical transactions and assumptions inherently are not reliable, and are especially so where they are not supported by active market data and evidence but determined by valuation models. We are concerned in particular with the proposal set out in paragraph 17 of the Exposure Draft which introduces the concept of *"alternative best use"* in determining the fair value of an item. We comment on this aspect further below.

We have stressed many times before that the IASB should consider and finalise the conceptual Framework first. It should speed up the Phase C *"Measurement"* conceptual framework project, which objective is to provide guidance for selecting measurement bases that satisfy the objectives and qualitative characteristics of financial reporting. We believe that the fair value measurements of hypothetical transactions are in many cases inappropriate because of the lack of verifiable evidence to support the assumptions made. To recognise the fair values changes in profit or loss or in the statement of comprehensive income where changes in fair value are not relevant to the purpose or intent of the entity also makes financial statements misleading and not useful.

We believe that the primary focus of financial statements should be to record *"actual transactions"* and information on *"unrealised"* holding gains and losses on hypothetical transactions should be secondary. However, the reverse appears to be the general direction of the IASB. Conceptually, if assets and liabilities are revalued at their true fair values, no gain or loss should ever arise from actual transactions as they have already been taken into account. The result of this approach is that financial statements may no longer be able to show the results of stewardship of management to assist investors in determining whether to re-appoint or replace management.

Definition of fair value

The Exposure Draft proposes an exit-price notion of fair value and defines 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"*. We do not agree with the new definition of fair value. An exit price under *"all"* circumstances is inconsistent and conflicts with the underlying assumption in the preparation of financial statements that an entity is a going concern and will continue in operation for the foreseeable future. In particular, the going concern assumption assumes that assets will be used or consumed in its operations and will not be sold (the exit price) at the reporting date.

For *"fair value"*, we prefer the current definition of *"the amount for which an asset could be exchanged, or liability settled, between knowledgeable, willing parties in an arm's length transaction"*. The new definition places too much emphasis on the *"seller"* whereas the current definition clearly recognises that the counterparty's perspective needs to be considered. The new definition hides the meaning in *"market participants"* which we believe could be easily overlooked. We believe that fair value from a seller's perspective will always be optimistic and will value items higher than that from the perspective of a buyer. Moreover, the reason for the sale for the seller and the reason for the buyer for the purchase (for example, for trading compared to for investment) will have an impact on pricing. An asset value is dependent on management's intended use for the item and how it is to be used with the company's other resources.

We also have concerns that determining an exit-price is in many circumstances impracticable especially for non-financial assets and liabilities that are not traded in an active market, for example, a plant that is consumed through use where there is no intention of disposal, or a liability that is settled through the delivery of goods and services. Moreover, moving to an exit-price notion conceptually will support arguments for upfront gains or losses on initial recognition of an item, which we believe is anomalous and disregards the efforts undertaken by independent parties in negotiating terms and pricing which in theory should represent the fair value of the item exchanged.

We therefore encourage the IASB to undertake a comprehensive review of the conceptual aspects of fair value measurements. To avoid confusion in application, the IASB may also consider the removal of the generic term "fair value" and use more precise terminology appropriate to meet different measurement objectives.

Most advantageous market

Under the proposals, a transaction is assumed to take place in the most advantageous market. The Exposure Draft also presumes *"the principal market"* or *"the market in which the entity would normally enter into a transaction for the asset or liability"* to be the most advantageous market. We consider that the proposed requirements over-complicate the fair value measurement process. We also believe that *"the market in which the entity would normally enter into a transaction for the asset or liability"* is readily understood, realistic and more relevant in application.

Highest and best use – alternative use

We conceptually do not agree with the highest and best use notion in determining fair value especially for non-financial items. Paragraph 20 of the Exposure Draft explains that an entity might operate a factory on a parcel of land even though the highest and best use of the land is to demolish the factory and build a residential property. In this case, it is proposed that the fair value of the land should include two fair value components, the fair value based on its current use plus recognition of an *"incremental"* fair value being the difference between the fair value of its current use and the *"alternative best use"*. We believe the proposals ignore reality and are impractical to apply, are biased towards the value of an individual asset and ignore synergies generated through the use of a group of assets in the operation of an entity and as a result lead to confusing information, especially where the fair value adjustments are recognised in the income statement.

Financial statements should show the accountability of management for the resources entrusted to it. We therefore question whether the notion of *"alternative best use"* assists in achieving the objectives of financial reporting. Applying the best alternative use concept would be inconsistent with the going concern concept which assumes that the company will continue in its chosen business and uses its assets accordingly. We believe alternative best use does not provide useful information about the economic resources controlled by the entity in predicting the ability of the entity to generate future cash flows from its chosen existing business.

We believe that if the concept of highest and best use is adopted it should be restricted to a valuation based on the current use of the relevant asset. Alternative use information may be included as note disclosure information only so that shareholders can decide whether to instruct management that the relevant asset should be put to an alternative use. We however expect that determining the alternative use value will be costly.

Fair value of liabilities

Under the proposals, the fair value measurement of a liability assumes that a liability is transferred to a market participant at the measurement date. Similar to our views relating to the exit-price notion, we believe that the fair value of a liability should reflect management's intention and obligations. We believe that most financial and non-financial liabilities are settled with the counter-parties or extinguished through performance rather than transferred. Moreover, most liabilities are non-transferable or only transferable with restrictions agreed by the creditor. We believe that re-measuring liabilities based on a hypothetical transaction without considering the restrictions on transfer is not realistic.

We also consider that a change in the credit risk of a company's own liability does not justify re-measurement of the liability to mirror adjustments normally made for credit risk in measuring the carrying value of loans and trade receivables. We do not agree that a change in an entity's own credit risk should be incorporated in the measurement of its liabilities. Re-measuring the carrying value of a company's liabilities does not provide relevant information to the users of financial statements and in fact would be misleading if the entity is regarded as a going concern.

Balance between benefit and cost

We note that the IASB's current focus is on relevance over other qualitative characteristics. For example, the Exposure Draft discusses the hierarchy of inputs in determining fair value but it does not include much discussion on whether the resulting fair value would be regarded as reliable. It appears to take the position that once the fair value route is chosen it must be computed notwithstanding the fact that the inputs are not verifiable. We are concerned with this approach and an inherent weakness of fair value hierarchy level 3 is that the inputs are based entirely on assumptions. Any one of the assumptions could be invalid, which in turn could have a significant impact on the valuation and reported information. We understand that the approach taken in some other jurisdictions is that where fair values cannot be determined reliably, fair value should not be used. We believe this approach is desirable and provides useful information for users of financial statements.

Training on determining fair value

During the financial crisis, many concerns were raised about the cost of performing the fair value measurements and whether the costs were greater than the benefits. We also believe that professional accountants as well as other professional advisors in general may have limited training or experience in valuation models especially those used in determining fair values for structured financial instruments. We are concerned whether they have adequate training and would recommend that if the Exposure Draft is issued in finalised form the Institute should make appropriate training courses available to its members.

We hope that the above comments are helpful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited

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Listing Division

CC/el

c.c. Mr. Paul Chow – Chief Executive
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