

Peter McCarthy
Deputy Managing Director

May 30, 2003

Mr. Tom Jones
Vice Chairman
International Accounting Standards Board
30 Cannon Street, London
United Kingdom



Dear Mr. Jones:

The IIF Accounting Task Force appreciates the International Accounting Standards Board providing an opportunity for further dialogue on topics of particular interest for our members. We believe that continuing dialogue between financial institutions and accounting standard setters can facilitate development of an effective accounting framework that recognizes consolidated financial market practices and enhances the reliability of accounts.

In particular, we appreciate the opportunity to comment on some aspects of the ED IAS 39 regarding fair valuation of financial instruments held in the trading portfolio. Before examining the specific areas of concern, Task Force members would like to emphasize two main messages to the IASB: First, that it is fundamental that accounting standards accommodate transparent and consolidated market practices. This is particularly relevant in the area of financial instruments accounting. Second, that the functionality and effectiveness of financial markets largely depend on a converging accounting framework. For this reason, the Accounting Task Force commends the IASB for its efforts in achieving convergence with other accounting standard setters and encourages its members to continue working in eliminating the differences that arise in the application of IAS and US GAAP standards. Several Task Force members believe that these convergence efforts would be most effective if agreement is reached on a principles-based approach, in avoidance of overly prescriptive guidelines.

As discussed in our May 16th meeting in London, members of the Task Force have articulated particular concern regarding some specific fair valuation topics, which are described in detail below. For most items, we describe the range of potential interpretations, signal possible inconsistencies with FASB standards and attach alternative proposals for re-wording. The Task Force formed a consensus on the main themes and messages presented in this letter rather. The Task Force, however, did not seek unanimity on specific language for the amended standards. A sizeable sub-group of the Task Force prepared a grid including relevant US GAAP and IAS Standards, as well as re-wording recommendations also reflected in Annex A. Two individual members also sent alternative re-wording proposals and those are attached as Annexes B and C.

Task Force members have indicated that the main areas of concern are:

1. Portfolio Valuation Methods.

The Accounting Task Force is concerned about the possible range of interpretation of Paragraph 99 of the Exposure Draft. In particular, Task Force members are concerned about the interpretation of this standard as requiring that all trading portfolios of financial instruments should be valued on a gross, individual instrument basis using bid/offer prices. This interpretation raises concern since it would ignore the effect of offsetting derivative positions and go against best industry practice. In addition, this interpretation could result in valuations that are not fair value resulting in inaccurate financial results.

Task Force members would like to note that it is best market practice to value derivative instruments on a net portfolio basis. As a going concern, an entity manages its portfolio on a net open risk position (derivative instruments are decomposed into the present value of cash flows that are valued on a mid-market basis, opposing positions are netted to determine the net risk position of the portfolio, and the appropriate bid/offer spreads are applied to the net positions).

Paragraph 99 indicates that the fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. Task Force members note with concern that this could be interpreted as requiring that derivatives be measured on a transaction-by-transaction basis and the bid/offer adjustment applied to each transaction. Such an interpretation not only goes against the text of paragraph 99 itself (which allows matching assets and liabilities to be netted and valued on a mid-market basis) but also would alter current industry best practices and therefore create serious practical implementation problems. Accordingly, the text should be modified so that this interpretation is avoided.

Alternative wording solutions are proposed, aimed to avoid the possibility of misinterpretation of the standard as requiring the valuation of portfolios on an individual transaction basis.

2. Valuation Techniques – Recognition of Initial Profits/Losses.

Paragraph 100A of ED IAS 39, when referring to valuation techniques, states that entities should calibrate the valuation technique and test it for validity using prices from actual transactions and that when the instrument being valued is purchased or sold in an arm's length transaction, the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received. While Task Force members agree that quoted prices are normally the best indicator of market value, it is also true that in several circumstances valuation techniques are necessary.

Concern exists that some have interpreted paragraph 100A to mean that the recognition of profit or loss based on model valuations is prohibited at the inception of the transaction. Task Force members believe that such interpretation would go against the accuracy and reliability of fair values in all those events where valuation techniques are employed. Furthermore, some members of the Task Force believe that this interpretation would create a significant divergence from US GAAP. In effect, EITF 02-3 allows the recognition of unrealized gains or losses at the inception of an instrument valued with a valuation technique as long as the data inputs to the model are observable. Paragraph 100A, as some might potentially interpret it, could result in the prohibition of recognizing profits at inception, irrespective of whether inputs to the valuation technique are observable.

Task Force members emphasize the importance and validity of valuation techniques, in particular in those circumstances where quoted prices are not available. The calibration requirement present in the proposed Paragraph 100A could in practice limit the use of estimates (even in those circumstances where

there is absolute transparency in model inputs) and result in unreliable models, with consequent inaccurate fair value results. Accordingly, Task Force members recommend the revision of the text.

3. Other Fair Valuation Issues.

a. Judgement Elements in Fair Valuation

In general, Task Force members recognize that the IASB has sought to provide guidance on fair valuation by developing new wording in Paragraphs 99 to 100D. However, some members have expressed concern for the potential misinterpretation of the standard as requiring a sequential and strict application of the guidance with total exclusion of judgement elements. Undoubtedly, judgment is essential when using estimates in particular for determining the fair value method and its inputs. Therefore, these members suggest introducing clarity in the proposals by expressly allowing several fair valuation methods.

b. Quoted Prices/Most Recent Transactions Prices

Task Force members would like to emphasize that although quoted prices and most recent transaction prices are normally the best indicators of market prices, this is not always the case. In reality, in several instances market conditions and dynamics determine the need of using estimates as the right tool for determining fair value (e.g. markets with single quotes, active OTC markets with poor price discovery conditions, market variables observable only through valuation techniques, etc). Accordingly, some Task Force members have presented re-wording proposals that clarify, where appropriate, that estimates are a valid form of determining fair value.

The Task Force thanks the IASB for the opportunity to engage in dialogue and commends the efforts made to craft an accounting framework that is compatible with market and standard setters' needs. We hope that our views are helpful in this effort, and look forward to continuing dialogue in the future on these and other issues of common interest.

Best regards.

Sincerely,

A handwritten signature in dark ink, appearing to read "Peter Bahner", with a stylized flourish at the end.

Attachments: US GAAP/IAS Comparison Grid; Re-wording proposals (Annexes A, B, C);

CC: Mr. Magnus Orrell, Project Manager, International Accounting Standards Board

IAS 39 Exposure Draft (marked for proposed changes)	Relevant US GAAP Currently in Effect (1)	FASB Fair Value Project Measurement Decisions	Comments/Recommendations
Fair Value Definition			
<ul style="list-style-type: none"> <i>Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. (IAS 32 p. 5)</i> 	<ul style="list-style-type: none"> The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. (SFAS 133 p. 540 – see also SFAS 140 p. 68 and SFAS 107 p. 5) 	<ul style="list-style-type: none"> Fair value of a financial instrument should be an estimated exit price – the price that would have been received or paid if it had been sold, exchanged, or settled on the measurement date. 	<ol style="list-style-type: none"> We would prefer that the definition of fair value include a reference to the exit price for a position. However, as this is not explicitly incorporated into the current US GAAP wording, and could potentially require re-exposure, we accept that this addition may not be possible.
Measurement Considerations			
<p><u>95. In determining the fair value of a financial asset or a financial liability for the purposes of applying this Standard or IAS 32, an entity shall apply paragraphs 98–100D. (old text – see paragraph 101)</u></p> <p>96. Situations in which fair value is reliably measurable include (a) a financial instrument for which there is a published price quotation in an active public securities market for that instrument, (b) a debt instrument that has been rated by an independent rating agency and whose cash flows can be reasonably estimated, and (c) a financial instrument for which there is an appropriate valuation model and for which the data inputs to that model can be measured reliably because the data</p>	<ul style="list-style-type: none"> Fair value is measured in a variety of ways depending on the nature of the instrument and the manner in which it is traded. (BD Guide p. 7.04 – see note 2 below) Related financial instruments may be traded in tandem, for example, as part of an arbitrage-trading strategy whose profitability is determined by the relative value of the financial instruments. It is appropriate to review the prices occurring on different exchanges or in different markets for all the individual financial instruments in the trading strategy at a given time in order to assign the proper value to all securities encompassed in that financial strategy. (BD Guide p. 7.03) 	<ul style="list-style-type: none"> The basis principles in estimating fair value are (1) maximise market inputs and minimize internal estimates and assumptions and (2) change estimation techniques only if an improvement can be demonstrated or if a change is necessary because of changes in availability of information. The mid-point of a bid-asked spread should be used as the basis for estimating fair value if the bid and asked prices are firm offers to buy or sell in an active market. The appropriate unit of measure for a group of similar, but not identical, financial instruments is the unit that would be expected to yield the highest price for assets and the lowest price for liabilities in a 	<ol style="list-style-type: none"> US GAAP acknowledges that the valuation of financial instruments is dependent upon the entity's own circumstances, trading strategy, and access to markets. However, the wording proposed in IAS (both in this section and in the sections to follow) has been interpreted by some to suggest that these factors should not be considered. This difference could lead to very different results. <p>We would prefer that this discrepancy be eliminated through re-drafting this opening section. However, as an easier alternative which could avoid re-exposure, we would recommend the following:</p>

<p>come from active markets.</p> <p>96.-97. [deleted]The fair value of a financial asset or financial liability may be determined by one of several generally accepted methods. Valuation techniques should incorporate the assumptions that market participants would use in their estimates of fair values, including assumptions about prepayment rates, rates of estimated credit losses, and interest or discount rates. Paragraph 167(a) requires disclosure of the methods and significant assumptions applied in estimating fair values.</p> <p>98. Underlying the definition of fair value is a presumption that an <u>enterprise entity</u> is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an <u>enterprise entity</u> would receive or pay in a forced transaction, involuntary liquidation, or distress sale. However, an enterprise takes its current circumstances into account in determining the fair values of its financial assets and financial liabilities. For example, the fair value of a financial asset that an enterprise has decided to sell for cash in the immediate future is determined by the amount that it expects to receive from such a sale. The amount of cash to be realised from an immediate sale will be affected by factors such as the current liquidity and depth of the market for the asset.</p>	<ul style="list-style-type: none"> ▪ The quoted price for a single trading unit in the most active market is the basis for determining market price and reporting fair value. This is the case even if placing orders to sell all of an entity's holdings of an asset or to buy back all of a liability might affect the price, or if a market's normal volume for one day might not be sufficient to absorb the quantity held or owed by an entity. (SFAS 107 p. 6) ▪ This appendix provides examples of procedures for estimating the fair value of financial instruments. The examples are illustrative and are not meant to portray all possible ways of estimating the fair value of a financial instrument in order to comply with the provisions of this Statement. (SFAS 107 p. 18) 	<p>market to which the entity has reasonable access. The incremental direct costs of sale or settlement must be considered in determining which unit of measure yields the optimum price.</p>	<p>(1) The first sentence in paragraph 97 could be reinstated as the opening sentence in paragraph 95.</p> <p>(2) The Board could consider reinstating the sentence in paragraph 98 which states that ‘an enterprise takes its current circumstances into account in determining the fair values of its financial assets and financial liabilities’ as the opening sentence in paragraph 98. The second sentence could then begin with ‘However’. By moving the sentence to the opening of paragraph 98, it would allow the necessary flexibility in valuing trading positions based upon exit strategies.</p>
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Quoted Prices			
<p><u>Active Market: Quoted Price</u></p> <p>99. The existence of published price quotations in an active market is normally the best evidence of fair value and when they exist they are used to <u>measure the financial asset or financial liability. A financial instrument is regarded as quoted in an active market if quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency.</u> The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction may provides evidence of the current fair value provided that there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an enterprise entity has matching asset and liability positions, it may appropriately use mid-market prices as a basis for establishing fair values. <u>The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active</u></p>	<ul style="list-style-type: none"> ▪ Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. (SFAS 133 p. 540 – see also SFAS 140 p. 68, SFAS 107 p. 20 and BD Guide p. 7.04) ▪ Prices for financial instruments may be quoted in several markets; generally, the price in the most active market will be the best indicator of fair value. (SFAS 107 p. 20) ▪ Ordinarily, management values a financial instrument traded on a recognized exchange based on quotations of completed transactions. A financial instrument traded on a recognized exchange on the valuation date is usually valued at the last quoted sales price. (BD Guide p. 7.05) ▪ If a quoted market price is available, the fair value is the product of the number of trading units times that market price. (SFAS 133 p. 540 – see also SFAS 140 p. 68 and SFAS 107 p. 5) 	<ul style="list-style-type: none"> ▪ Quoted market prices are the best evidence of an unrestricted equity security's fair value. If a current quoted market price is available for an unrestricted security, the fair value of that security is the product of the number of trading units of the security multiplied by the quoted market price. Large blocks of an identical equity security should not be reduced by a 'block discount'. 	<p>3. In practice, the delineation between active markets and inactive markets is not as clear as IAS 39 assumes. There are examples of active markets without firm quotes and inactive markets with quoted prices. We would therefore recommend that the title to this section be titled simply 'Quoted Price', which will be consistent with US GAAP and easier to apply in practice.</p> <p>4. While we agree that quoted market prices are normally the best evidence of fair value, there are some circumstances when those quotes should be challenged. We would therefore recommend that the word 'normally' be reinstated in the opening sentence and the second half of the sentence be removed. While this is a slight advancement over the guidance in current US GAAP, we believe it is more appropriate guidance for ensuring that fair value will, in fact, be achieved.</p> <p>5. Furthermore, the second sentence in paragraph 99, which defines an active market, could lead to implementation difficulties. In particular, valuation models are often required in active markets because quoted prices may be indicative only and not firm prices at</p>

<p><u>markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.</u></p>			<p>which dealers are prepared to transact. Additionally, prices for a product may vary across markets. We would therefore recommend that this sentence be deleted to avoid confusion and ensure that only appropriate quoted market prices are used to value financial instruments.</p> <p>6. IAS 39 suggests that assets are ‘usually’ priced at the bid and liabilities are ‘usually’ priced at the offer. While this is the case with many securities, it is often inappropriate for two reasons:</p> <p>First, derivatives are quoted based upon whether the transaction is a long or short position. For example, an interest rate swap where one pays the fixed leg (a long position) would be closed out by a counterparty quoting a bid price. This swap could be an asset or a liability depending upon the current floating rate curve. Regardless of whether it is an asset or liability, it should NOT be priced at the offer.</p> <p>Second, a derivatives trader will often be able trade at prices which are at or near the mid price for a particular instrument. As a result, the appropriate exit price for the transaction is not necessarily the bid or offer.</p> <p>We would prefer that the guidance refer to fair value as the exit price for the position held.</p>
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			<p>However, as this change might require re-exposure, we would be comfortable if the words ‘is usually’ are amended to be ‘may often be’.</p> <p>7. Paragraph 99 of the IAS ED currently states: ‘when an entity has matching asset and liability positions, it may appropriately use mid-market prices as a basis for establishing fair values. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price.’ While these statements may appear to be consistent with US GAAP, the specific wording differences have led to very different interpretations. In particular, there is uncertainty as to the meaning of ‘matching asset and liability positions’ and whether this guidance can be applied to offsetting derivative positions (as currently applied in practice). This uncertainty is increased by the explicit reference to ‘portfolio’ in the second sentence. As a result, many readers have interpreted this paragraph as a requirement that all financial instruments must be valued at their respective individual bid or offer price regardless of the first statements which implies that some positions should be valued at mid. We therefore recommend that the sentences be amended to read consistently with US GAAP. In particular, we would replace ‘matching asset and liability</p>
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			positions' with 'offsetting positions' in the first sentence and we would delete the words 'a portfolio of' in the second sentence. We would also recommend reinstating the wording from paragraph 98 regarding illiquid instruments.
No Quoted Prices			
<p><u>No Active Market: Recent Market Transaction</u></p> <p>100. If the market for a financial instrument is not an active market, the best evidence of fair value is obtained by reference to recent market transactions between knowledgeable, willing parties in an arm's length transaction. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, as appropriate. published price quotations may have to be adjusted to arrive at a reliable measure of fair value. If there is infrequent activity in a market, the market is not well established (for example, some 'over the counter' markets) or small volumes are traded relative to the number of trading units of a financial instrument to be valued, quoted market prices may not be indicative of the fair value of the instrument. In some cases where the volume traded is relatively small, a price quotation for a larger block may be available from the market maker in that instrument. In other circumstances, as</p>	<p><u>SFAS 133/140:</u></p> <ul style="list-style-type: none"> ▪ If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward 	<ul style="list-style-type: none"> ▪ Estimates of fair value should be based on prices for identical instruments if they are regularly available at or near the measurement date. ▪ When using estimation techniques not based upon observable prices, the following general guidelines should determine which technique to use: ▪ Use an estimation technique that incorporates the factors that market participants would consider in setting a price. ▪ Use an estimation technique commonly used by market participants to negotiate prices of the type of instruments being measured if such a technique is available. ▪ Internally developed techniques should be consisted with accepted economic methodologies for pricing the type of financial instruments being measured and should be tested for validity using prices from actual transactions. ▪ The guidance if FASB Concepts Statement No. 7 should be applied when using discounted cash flow computations to measure fair value. 	<p>8. As noted above, we would recommend that the title of this section be changed to 'no quoted prices' or 'valuation technique' to ease application.</p> <p>9. We disagree with the assertions in paragraph 100. Although a recent market transaction is valuable information in determining the fair value of an instrument absent a quoted price, that recent transaction price will not be accepted as the appropriate value without employing a valuation technique which incorporates all relevant information. We would therefore recommend that paragraph 100 be deleted in its entirety or incorporated into paragraph 100A as an input to the valuation process.</p> <p>10. While US GAAP appreciates the need for judgement in valuing financial instruments, the wording in paragraph 100A suggests that this judgement somehow casts doubt on the quality of the financial statements. We would therefore strongly recommend that the following amendments are adopted:</p>

<p>well as when a quoted market price is not available, estimation techniques</p> <p><u>No Active Market: Valuation Technique</u></p> <p>100A. If an entity cannot otherwise determine fair value, it uses a valuation technique may be used to determine to estimate fair value with sufficient reliability to satisfy the requirements of this Standard. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. An entity calibrates the valuation technique and tests it for validity using prices from actual transactions. For example, when the instrument being valued is purchased or sold in an arm's length transaction, the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received.</p> <p>100B. Techniques Valuation techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique commonly used by market participants to</p>	<p>contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction. (SFAS 133 p. 540 – see also SFAS 140 p. 69)</p> <ul style="list-style-type: none"> Estimates of expected future cash flows, if used to estimate fair value, shall be based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered either directly, if applying an expected cash flow approach, or indirectly through the risk-adjusted discount rate, if determining the best estimate of future cash flows. (SFAS 140 p. 70) <p><i>SFAS 107:</i></p> <ul style="list-style-type: none"> For financial instruments that do not trade regularly, or that trade only in 		<ul style="list-style-type: none"> The first sentence in 100A should be amended to read 'if a quoted price in an active market does not exist, it uses a valuation technique to estimate fair value.' The reference to the IASC framework which was included in paragraph 102 should be reinstated to acknowledge the importance of judgement in value determination. <p>11. As noted in point 7 above, there is uncertainty as to whether industry best practices can be applied to trading portfolios. We would therefore strongly recommend that explicit wording be included in the standard to clarify that trading portfolios may be valued based upon mid-market levels less specific adjustments for net open risk positions, or on appropriate bid or offer levels. Mid-market valuation adjustments allow for expected future costs such as unearned credit spread, close-out costs, investing and funding costs, and administrative costs. Marking to mid-market less adjustments specifically defines and quantifies adjustments that are implicitly assumed in the bid or offer method.</p> <p>12. US GAAP explicitly recognises that profit can be at the inception of a transaction (as long as that profit can</p>
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<p><u>price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.</u></p> <p><u>100C. In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price for the financial instrument.</u> In applying discounted cash flow analysis, an enterprise entity uses the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made. <u>When the term of an instrument extends beyond the period for which market prices are available, the valuation technique uses market prices for the period they are available and reasonable extrapolations of those market prices for later periods on the basis of historical experience of price changes under normal market conditions and all other available information. In particular, any assumed change in market prices is supported by reasonable evidence consistent with any available market forward prices.</u></p> <p><u>100D. The initial acquisition or origination of a financial asset or</u></p>	<p>principal-to-principal markets, an entity should provide its best estimate of fair value. Judgements about the methods and assumptions to be used in various circumstances must be made by those who prepare and attest to an entity's financial statements. The following discussion provides some examples of how fair value might be estimated. (SFAS 107 p. 22 – examples follow in p. 23-29 using words such as fair value ‘may be’)</p> <ul style="list-style-type: none"> ▪ The Board realizes that estimating fair value when quoted market prices are unavailable may, in some cases, require considerable judgment. However, the Board noted that a considerable degree of judgment also is needed when complying with other longstanding accounting and reporting requirements. (SFAS 107 p. 59) <p><i>BD Guide:</i></p> <ul style="list-style-type: none"> ▪ If quoted market prices are not available, management's best estimate of fair value should be based on the consistent application of a variety of factors available to management. These factors are discussed in the following paragraphs. (BD Guide p. 7.04) ▪ A broker-dealer may adopt a policy that is applied on a consistent basis and that uses one of the following: <ul style="list-style-type: none"> ▪ An average of bid and asked prices ▪ Bid prices for long positions and asked prices for short positions ▪ Some average of price quotations of a representative selection of market 		<p>be justified through observable evidence). On the contrary, several references in IAS (some of which will be addressed later in this document) imply that upfront profit is forbidden in all cases. This interpretation is evidenced by PWC’s April 2003 survey ‘Illuminating Value: The Business impact of IFRS’ which states that Derivatives ‘will have to marked at fair value, which is the value of similar products in the market. By definition, therefore, there will be no upfront profit.’</p> <p>Our understanding is that these interpretations are based primarily upon the wording in the last two sentences of paragraph 100A, which suggests that all models should be calibrated to cost regardless of the amount of observable data which would indicate otherwise. This will easily lead to inconsistent modelling parameters being required for similar financial instruments. We would therefore strongly recommend that the last two sentences be deleted in their entirety.</p> <p>This deviation is perhaps the most significant harmonisation issue.</p> <p>13. Finally, in our view, paragraphs 100B through 100D contain elaboration on the guidelines provided in paragraph 100A. As such, if the Board believes this information is necessary, we would</p>
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<p><u>incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a debt security or loan asset), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (ie similar remaining maturity, cash flow pattern, currency, credit risk, collateral, and interest basis). Alternatively, provided there is no change in the credit risk of the debtor after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date.</u></p> <p>101. If a market price does not exist for a financial instrument in its entirety but markets exist for its component parts, fair value is constructed on the basis of the relevant market prices. If a market does not exist for a financial instrument but a market exists for a similar financial instrument, fair value is constructed on the basis of the market price of the similar financial instrument.</p>	<p>makers quoting on a particular financial instrument</p> <ul style="list-style-type: none"> ▪ A valuation within the range of bid and asked prices considered best to represent value in the circumstances. Asked prices should not be used for long positions nor should bid prices be used for short positions. (BD Guide p. 7.08) ▪ If there is a limited amount of trading activity for a financial instrument (that is, if the instrument is thinly traded), the reliability of the market quotation and other market information (for example, volume data) should be evaluated by management. In instances where the fair value as determined by management is lower than the market quotation, the financial instruments should be valued at such fair value. (BD Guide p. 7.09) ▪ A broker-dealer may have to determine the fair values of financial instruments for which there are no readily available price quotations or for which readily available price quotations are unreliable. These price quotations may be deemed unreliable because the financial instruments may have restrictions associated with them (such as not being registered) or may be thinly traded or traded in a market where sales are infrequent. In such cases, it may be appropriate for these financial instruments to be valued at fair value as determined in good faith by management. To determine fair value, management should 		<p>suggest that it be moved to Appendix B and amended to read more as guidance versus a requirement by changing ‘the entity uses’ to ‘the entity may use’. We would also recommend that the word ‘foundation’ in paragraph 100D be changed to ‘indicator’ to maintain consistency with US GAAP.</p>
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	<p>satisfy itself that —</p> <ul style="list-style-type: none"> ▪ All appropriate factors relevant to the value of financial instruments for which price quotations are not readily available have been considered. ▪ The procedures for arriving at the fair value of each financial instrument are reasonable and consistently applied. ▪ The underlying documentation supports the fair value estimates. (BD Guide p. 7.10) ▪ To the extent considered necessary, management should take into consideration all indications of value that are available in determining the fair value assigned to a particular financial instrument. (BD Guide p. 7.11) ▪ Management may use a variety of methods to assist in determining the valuation of a financial instrument. These methods include analogy to reliable quotations of similar financial instruments, pricing models, matrix pricing, and other formula-based pricing methods. These methodologies incorporate factors for which published market data may be available. For instance, the mathematical technique known as <i>matrix pricing</i> may be used to determine the values based on market data available with respect to the issue and similar issues without exclusive reliance on issuer-specific quoted market prices. (BD Guide p. 7.13) ▪ Pricing methods may also be based 		
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	<p>on a multiple of earnings or a discount (or less frequently, a premium) from market of a similar, freely traded security; on a yield to maturity with respect to debt issues; or on a combination of these and other methods. In addition, with respect to derivative products, other factors (such as volatility, anticipated future interest rates, and term to maturity) should be considered. (The Group of Thirty Report, <i>Derivatives Practices and Principles</i>, contains several recommendations regarding dealers' pricing, including that derivative portfolios be valued based on mid-market levels less specific adjustments.) If such methods are used, management should continuously review the appropriateness of such methods to satisfy themselves that the resulting valuations are fair. (BD Guide p. 7.14)</p> <p>EITF 02-03</p> <ul style="list-style-type: none"> ▪ The FASB staff believes that, in the absence of (a) quoted market prices in an active market, (b) observable prices of other current market transactions, or (c) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of the arrangement. Therefore, in the FASB staff's view an entity should not recognize an unrealized gain or loss at inception of a derivative 		
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	<p>instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data. For example, a valuation technique that includes extrapolated price curves with little or no observable market inputs for any significant duration of the instrument should not result in an initial fair value estimate that differs from the transaction price for the instrument taken as a whole, because, in this example, the transaction price is the best evidence of the instrument's fair value at that point in time. (EITF 02-03 p. 17 fn3)</p>		
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Annex A

RECOMMENDED CHANGES TO THE IAS EXPOSURE DRAFTS (marked for recommendations)

IAS 32: **Definitions**

5. The following terms are used in this Standard with the meanings specified:

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

IAS 39: **Fair Value Measurement Considerations**

95. The fair value of a financial asset or liability may be determined by one of several generally accepted methods. In determining the fair value of a financial asset or a financial liability for the purposes of applying this Standard or IAS 32, an entity shall apply paragraphs 98–100. (old text – see paragraph 101)

~~96. Situations in which fair value is reliably measurable include (a) a financial instrument for which there is a published price quotation in an active public securities market for that instrument, (b) a debt instrument that has been rated by an independent rating agency and whose cash flows can be reasonably estimated, and (c) a financial instrument for which there is an appropriate valuation model and for which the data inputs to that model can be measured reliably because the data come from active markets.~~

~~96.-97. [deleted]~~ The fair value of a financial asset or financial liability may be determined by one of several generally accepted methods. Valuation techniques should incorporate the assumptions that market participants would use in their estimates of fair values, including assumptions about prepayment rates, rates of estimated credit losses, and interest or discount rates. Paragraph 167(a) requires disclosure of the methods and significant assumptions applied in estimating fair values.

98. An enterprise takes its current circumstances into account in determining the fair values of its financial assets and liabilities. However, underlying the definition of fair value is a presumption that an enterprise is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an enterprise would receive or pay in a forced transaction, involuntary liquidation, or distress sale. ~~However, an enterprise takes its current circumstances into account in determining the fair values of its financial assets and financial liabilities. For example, the fair value of a financial asset that an enterprise has decided to sell for cash in the immediate future is determined by the amount that it expects to receive from such a sale. The amount of cash to be realised from an immediate sale will be affected by factors such as the current liquidity and depth of the market for the asset.~~

Using Quoted Prices

99. The existence of published price quotations in an active market is normally ~~normally~~ the best evidence of fair value. A financial instrument is regarded as quoted in an active market if quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency. ~~The appropriate quoted market price for an asset held or liability to be issued will often be the current bid price and, for an asset to be acquired or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction may provide evidence of the current fair value provided that there has not been a significant change in economic circumstances between the transaction date and the reporting date. The fair value of financial instruments is the product of the number of units of the instrument and its quoted market price, as affected by factors such as current liquidity and depth of the market for the instrument. However, when an enterprise has offsetting positions, it may appropriately use mid-market prices as a basis for establishing fair values. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.~~

Using a Valuation Technique

100A. A valuation technique may be the most appropriate method to estimate fair value with sufficient reliability to satisfy the requirements of this standard. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. While the determination of fair values absent a quoted price requires judgement, the IASC Framework states: 'In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.' 100B. In applying valuation techniques to trading portfolios, entities may determine fair value based on mid-market levels less specific adjustments for net open risk positions, or on appropriate bid or offer levels. Mid-market valuation adjustments allow for expected future costs such as unearned credit spread, close-out costs, investing and funding costs, and administrative costs. Marking to mid-market less adjustments specifically defines and quantifies adjustments that are implicitly assumed in the bid or offer method.

INFORMATION TO BE INCLUDED IN APPENDIX C, IF INCLUSION IS DEEMED NECESSARY

100B. Techniques. Valuation techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity may use that technique.

100C. In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price for the financial instrument. In applying discounted cash flow analysis, an enterprise entity uses the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made. When the term of an instrument extends beyond the period for which market prices are available, the valuation technique uses market prices for the period they are available and reasonable extrapolations of those market prices for later periods on the basis of historical experience of price changes under normal market conditions and all other available information. In particular, any assumed change in market prices is supported by reasonable evidence consistent with any available market data such as forward prices.

100D. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides an indicator for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a debt security or loan asset), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (ie similar remaining maturity, cash flow pattern, currency, credit risk, collateral, and interest basis). Alternatively, provided there is no change in the credit risk of the debtor after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date.

101. If a market price does not exist for a financial instrument in its entirety but markets exist for its component parts, fair value is constructed on the basis of the relevant market prices. If a market does not exist for a financial instrument but a market exists for a similar financial instrument, fair value is constructed on the basis of the market price of the similar financial instrument.

ANNEX B

Recommended Amendments to Paragraphs 99-100

Paragraph 99

The existence of published price quotations in an active market is normally the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability. A financial instrument is regarded as quoted in an active market if quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency. The appropriate quoted market price for an asset held (long position) or liability to be issued is usually the current bid price and, for an asset to be acquired (short position) or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction provides evidence of the current fair value provided there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an entity has offsetting asset and liability positions, it may appropriately use mid-market prices as a basis for establishing fair values. The fair value of a portfolio of financial instruments is the product of its net market risk position and quoted market price. If marked to mid-market, adjustments are required for items such as credit risk, administrative costs, and closeout costs, thereby bringing the net position to the appropriate bid/offer levels. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

100A

If an entity cannot otherwise determine fair value, it should use a valuation technique to estimate fair value. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Therefore, the valuation technique should (a) incorporate all factors that market participants would consider in setting a price and (b) consistent with accepted economic methodologies for pricing financial instruments.

100B

Valuation techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique that has been demonstrated to provide reliable estimates of fair value, whether through actual use in the market or through statistical valuation techniques appropriately documented and tested by the preparer, the entity should use that technique. Any changes in the fair value of the instruments by using these models should be recognized in profit or loss for the period.

Annex C

Fair Value Measurement Considerations

95. In determining the fair value of a financial asset or a financial liability for the purposes of applying this Standard or IAS 32, an entity shall apply paragraphs 98– 100D.

96. - 97. [deleted by IASB]

98. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale.

Fair Value: Quoted Prices in Active Markets

99. The existence of published price quotations in an active market is **normally** the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability. A financial instrument is regarded as quoted in an active market if quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction provides evidence of the current fair value provided there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an entity has matching asset and liability positions, it may appropriately use mid- market prices as a basis for establishing fair values. The fair value of a portfolio of identical financial instruments is the product of the number of units of the instrument and its quoted market price reduced, if necessary, by a block discount to arrive at the best estimate of fair value. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

Fair Value: Valuation Technique

100.If quoted market prices in active markets are not available, the entity shall apply judgment in determining the best estimate of fair value, using all information available in the circumstances. The best estimate of fair value shall consider prices for recent market transactions between knowledgeable, willing parties in an arm's length transaction, as well as prices for similar assets or similar liabilities and the results of other valuation techniques.

100A. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments.

100B. Valuation techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

100C. In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price for the

financial instrument. In applying discounted cash flow analysis, an entity uses the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made. When the term of an instrument extends beyond the period for which market prices are available, the valuation technique uses market prices for the period they are available and reasonable extrapolations of those market prices for later periods on the basis of historical experience of price changes under normal market conditions and all other available information. In particular, any assumed change in market prices is supported by reasonable evidence consistent with any available market forward prices.

100D. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a debt security or loan asset), its fair value can be determined by reference to current market conditions for similar debt instruments (i.e. similar remaining maturity, cash flow pattern, currency, credit risk, collateral, and interest basis). Alternatively, provided there is no change in the credit risk of the debtor after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date.

100E. For dealers, derivatives shall be valued as a portfolio in accordance with The Group of Thirty Report, *Derivatives Practices and Principles*, based on mid-market levels less specific adjustments for net open risk positions, or on appropriate bid or offer levels. Mid-market valuation adjustments allow for expected future costs such as unearned credit spread, close-out costs, investing and funding costs, and administrative costs. Marking to mid-market less adjustments specifically defines and quantifies adjustments that are implicitly assumed in the bid or offer method.