Fair Value, Historical Cost, Replacement Cost... How Should Assets and Liabilities Be Measured on Initial Recognition?

Depending on whom you ask, the answer to this question can vary. How would users of financial statements — investors, creditors and their advisors — answer?

In this fast-paced modern era, vast amounts of up-to-date and dependable information are only a couple of keystrokes away. Such information impacts investors' decisions to buy or sell investments, creditors' decisions to lend money or suppliers' decisions to do business. Financial statements are an important source of information these users look to.

With these users in mind, the International Accounting Standards Board (IASB) asked Canadian Accounting Standards Board staff to undertake a research project to answer this controversial question. Its objective is to develop, from first principles, bases for measuring assets and liabilities on initial recognition. In response, the IASB recently issued the Discussion Paper, "Measurement Bases for Financial Reporting — Measurement on Initial Recognition."

The Discussion Paper analyzes possible measurement bases that could be used to value an asset or liability when it is first included on the balance sheet. Possible measurement bases, such as historical cost, current cost, net realizable value and fair value, are analyzed against the criteria for decision-useful information established in the conceptual framework.

The proposal
Fair value is the most relevant measurement basis on initial recognition provided it can be reliably measured. Fair value is defined in the Discussion Paper as "the amount for which an asset or liability could be exchanged between knowledgeable, willing parties in an arm's length transaction."

Fair value is reasoned to be the most relevant measurement basis because it reflects market risk preferences and market expectations with respect to the amounts, timing and uncertainty of future cash flows. Market forces serve to resolve diverse entity expectations regarding the value of an asset or liability to the single price that impartially reflects all information available to the marketplace at a point in time. In that regard, fair value is preferred by users in making informed business and investment decisions, because it reflects the up-to-date expectations of the market with respect to an asset's ability to generate future cash flows discounted at the risk-adjusted rate of return available in the marketplace.

Market view
To reinforce the role of a market when determining a fair value, the Discussion Paper emphasizes the market value measurement objective in estimating fair value — that is, to reflect the price that an asset or a liability would be exchanged for in an open, active and competitive market. Thus, the fair value objective should be to reflect the market's view, rather than an entity's or its management's preferences and expectations.

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Measuring fair value
As sources of information have evolved, so have the methods by which financial measurements are determined. Developments in capital markets, measurement practices and techniques (such as option pricing models), and information technology, have substantially improved accountants' abilities to estimate fair value of many assets and liabilities.

Estimating the fair value of an asset or liability is straight forward when its current trading price is observable on an active stock exchange. Measuring the fair values of many types of assets and liabilities that are not traded in active markets is more complex and subject to uncertainty. The Discussion Paper concludes that in some situations, fair value is not capable of reliable estimation. Based on the analysis of the properties of fair value and alternative measurement bases, the Discussion Paper proposes a four-level measurement hierarchy on initial recognition:

Estimates of fair value
Level 1 — observable market prices, including market-based adjustments;
Level 2 — accepted valuation models or techniques; all significant inputs are consistent with those that market participants can be expected to use;
Substitutes for fair value (when fair value cannot be reliably estimated using Levels 1 or 2)
Level 3 — current cost (i.e., reproduction cost and replacement cost), with the possibility of substituting historical cost (which will likely often be a substitute); or
Level 4 — models and techniques that use entity inputs.

Levels 3 and 4 cannot be justified to represent market expectations. Accordingly, the Discussion Paper recommends they not be described as "fair value".

Global view
During the Discussion Paper's development, the measurement concepts, analyses and proposed conclusions were discussed by members of the IASB, and Board and staff members from other national standard setters. The IASB and the Financial Accounting Standards Board (FASB) will consider the Discussion Paper's recommendations in their Joint Conceptual Framework Project.

The FASB's current Fair Value Measurement Project is developing a fair value hierarchy that differs in some significant respects from the measurement hierarchy for assets and liabilities on initial recognition proposed in the Discussion Paper. The IASB expects to look to the results of the FASB's Fair Value Measurement Project in developing guidance on fair value measurement. We encourage you to consider the Discussion Paper's proposals as you evaluate forthcoming IASB and IASB exposure materials on Fair Value Measurement.

Differences between the Discussion Paper proposals and those in the FASB's Fair Value Measurement Project include the following:

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- Scope — The Discussion Paper considers only what the measurement basis should be on initial recognition — it concludes that the measurement objective should be fair value. However, it concludes that there are some significant situations in which fair value is not likely to be reliably determinable, for which it proposes other measures that could be used as substitutes for fair value. In contrast, the FASB's current project considers only how fair value should be determined when FASB standards require the use of fair value measurement.
- Definition — The forthcoming FASB Statement Fair Value Measurements is expected to define fair value as an exit value. The Discussion Paper does not view fair value as either an entry value or an exit value. Its definition is in terms of "the amount for which an asset or liability could be exchanged…" This will lead to differing determinations of fair value in certain situations.
- Measurement hierarchy — The hierarchy of sources that can be used to determine fair value in the forthcoming FASB Statement on fair value measurement includes at the bottom of the hierarchy certain estimates that the Discussion Paper would not consider to qualify as reliable (representationally faithful) fair value measures. This has important implications for how the term fair value would be used in accounting standards.

Share your view

These proposals and supporting analyses are intended to help shape future global accounting standards. It is hoped that the Discussion Paper will enable users, preparers, auditors and other interested parties to better understand the issues and their importance, and be in an informed position to assess and perhaps challenge the proposals. The IASB published the Discussion Paper in November 2005 for comment by May 19, 2006.

To participate in the development of future global accounting standards, share your views of how assets and liabilities should be measured on initial recognition.

A copy of the Discussion paper and Invitation to Comment can be found on the IASB website at http://www.iasb.org/current/dp_pv.asp

Further information on the Measurement Objectives Project can be found on the IASB website at www.iasb.org, under Active Research Topics.

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