

## Heads Up

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## IASB's Exposure Draft Proposes Expanded Guidance on Fair Value Measurement.

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### Introduction

On May 28, 2009, the International Accounting Standards Board (IASB) issued an exposure draft (ED), *Fair Value Measurement*. The IASB's intention is to replace all existing guidance on fair value measurement in IFRS accounting literature with a single standard that is equivalent to FASB Statement No. 157, *Fair Value Measurements*, under U.S. GAAP. (For a quick view of the differences between the IASB's proposal and Statement 157, see the [Appendix](#) of this *Heads Up*.) The ED defines fair value and explains how to determine it, but does not introduce any new or revised requirements regarding which items should be measured or disclosed at fair value. Comments on the ED are due by September 28, 2009; a final standard is expected to be issued in 2010.

### Key Elements of the Proposal

The ED defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly [i.e., not forced] transaction between market participants at the measurement date." The proposed standard would apply to all fair value measurements or disclosures under IFRSs, with one exception (the requirements of paragraph 49 of IAS 39, which relate to the fair value of financial liabilities with a demand feature). Therefore, both financial instruments and nonfinancial items would be within the ED's scope.

Paragraph B1 of the ED states that an entity must determine the following when measuring fair value:

- The "particular asset or liability that is the subject of the measurement (consistently with its unit of account)."
- "For an asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use)."
- The "most advantageous market for the asset or liability."
- The "valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use in pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised."

### The Market Participant in the Most Advantageous Market

Central to fair value measurement is the price that would be achieved if the asset were sold (or the liability transferred) to a market participant in the most advantageous market

The determination of the price that a market participant in the entity's most advantageous market would pay for an asset (or would accept for taking on a liability) will require judgment.

that the reporting entity has access to. The most advantageous market is the market that, from the reporting entity's perspective, maximizes the amount that would be received upon sale of the asset (or minimizes the amount that would be paid to transfer the liability), after transaction and transportation costs are taken into account. The market in which the entity normally transacts would be presumed to be the most advantageous market. Note, however, that transaction costs do not form part of the fair value measurement because they are not a characteristic of the asset or liability. Regarding transportation costs, paragraph 16 of the ED states, "If location is a characteristic of the asset (as might be the case for a commodity), the price in the most advantageous market shall be adjusted for the costs, if any, that would be incurred to transport the asset to or from that market."

The determination of the price that a market participant in the entity's most advantageous market would pay for an asset (or would accept for taking on a liability) will require judgment. In making this determination, an entity should assume a "market participant" to (1) not be a related party, (2) be knowledgeable, and (3) be willing and able to enter into a transaction for the asset or liability.

There may be no actual transaction for the asset or liability as of the measurement date (e.g., when an entity determines fair value at the end of the reporting period to subsequently measure an asset or liability). However, the absence of an actual transaction does not change the objective of fair value. In determining fair value, an entity assumes a hypothetical transaction as of the relevant date and uses assumptions that market participants would use in pricing the asset or liability. When transactions are directly observable in a market, the determination of fair value is relatively straightforward. When they are not, a valuation technique is used.

### Asset-Specific Valuations

Paragraph 17 of the ED states that when considering the price that a market participant would pay for an asset, an entity would be required to consider the "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." Paragraph 17 further notes that the phrase "highest and best use" reflects the use of an asset that "would maximise the value of the asset or the group of assets and liabilities . . . within which the asset would be used, considering uses of the asset that are physically possible, legally permissible, and financially feasible at the measurement date." Moreover, paragraph 18 of the ED states:

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, an entity need not perform an exhaustive search for other potential uses if there is no evidence to suggest that the current use of an asset is not its highest and best use.

In addition, paragraph 22 of the ED indicates that the "highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset." The "in-use" valuation premise would apply "if the asset would provide maximum value to market participants principally through its use in combination with other assets and liabilities as a group." Under the in-use valuation premise, "the fair value of the asset is measured on the basis of the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets and liabilities . . . available to market participants." The "in-exchange" valuation premise would apply "if the asset would provide maximum value to market participants principally on a stand-alone basis." Under the in-exchange valuation premise, "the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants who would use the asset on a stand-alone basis." As stated in paragraph 24 of the ED, "an entity shall use an in-exchange valuation premise when measuring the fair value of a financial asset. . . . As a result, the in-use valuation premise is not relevant for financial assets."

## Liability-Specific Valuations

Paragraph 25 of the ED states:

A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability continues and the market participant transferee would be required to fulfill it); it is not settled with the counterparty [to the liability].

Further, paragraph 26 notes that when there is no observable market price for the transfer of a liability, an entity would be required to measure the fair value of a liability by “using the same methodology that the counterparty would use to measure the fair value of the corresponding asset” (since the counterparty will measure the fair value of its asset on the basis of transferring it, rather than demanding settlement from the obligor). Under paragraph 27 of the ED, an entity would need to “adjust the observed price of the [counterparty’s] asset for features that are present in the asset but not present in the liability, or vice versa.” Paragraph 28 stipulates that “[i]f there is no corresponding asset for a liability . . . an entity shall estimate the price that market participants would demand to assume the liability using present value techniques . . . or other valuation techniques.” In addition, under paragraph 31 of the ED, “A restriction on an entity’s ability to transfer a liability to another party does not affect the fair value of the liability.”

When measuring the fair value of a liability, an entity must consider nonperformance risk (i.e., the risk that the entity will not fulfill an obligation). Nonperformance risk includes the entity’s own credit risk.

## Valuation Techniques

Paragraphs 38(a)–(c) of the ED describe three approaches for using a valuation technique to determine fair value:

- *Market approach* — An entity “uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business).”
- *Income approach* — Future amounts, such as cash flows or income and expenses, are converted to a single discounted present value amount.
- *Cost approach* — An entity “reflects the amount that would currently be required to replace the service capacity of an asset (often referred to as current replacement cost).”

An appropriate valuation technique (1) will be consistently applied, (2) will maximize the use of relevant observable inputs (and minimize unobservable inputs), and (3) will be calibrated periodically to actual transactions.

In addition, paragraph 48 of the ED notes that a “quoted price in an active market provides the most reliable evidence of fair value” and should be used to measure fair value, except in limited circumstances. The ED lists factors that may indicate a market is not active but reemphasizes that even when a market is not active, the objective of a fair value measurement remains the same (i.e., the “price that would be received to sell an asset or paid to transfer a liability in an orderly transaction [not a forced liquidation or distress sale] between market participants at the measurement date” under current market conditions). As indicated in paragraph B12 of the ED, “If the evidence indicates that a transaction is not orderly, an entity places little, if any, weight . . . on that transaction price when measuring fair value.”

## Fair Value at Initial Recognition

The ED indicates that in many cases, the price paid to acquire the asset or received to assume the liability (e.g., entry price) will equal the exit price. In such cases, the fair value of an asset or liability at initial recognition equals the entry (transaction) price. To determine whether fair value at initial recognition equals the transaction price, the entity would consider factors specific to the transaction and the asset and liability. Paragraph 36 of the ED notes that at initial recognition, the transaction price constitutes the best available evidence of an asset’s or liability’s fair value, except in the following circumstances:

When measuring the fair value of a liability, an entity must consider nonperformance risk.

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- The “transaction is between related parties.”
- The transaction “takes place under duress” or is a forced transaction.
- The “unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value.”
- The “market in which the transaction takes place is different from the market in which the entity would sell the asset or transfer the liability.”

Paragraph 37 of the ED further notes that if an entity initially measures an asset or liability at fair value (as required or permitted by an IFRS) and “the transaction price differs from fair value, the entity recognises the resulting gain or loss in profit or loss unless the IFRS requires otherwise” (e.g., IAS 39, *Financial Instruments: Recognition and Measurement*, requires that day one profits be deferred in some cases, and no changes have been proposed to this requirement).

## Disclosures

Many of the ED’s proposed disclosures for financial instruments are already required under IFRS 7, *Financial Instruments: Disclosures* (as amended in March 2009). However, the ED proposes many new disclosures for nonfinancial items within its scope.

Fair value measurement disclosures are based on a hierarchy in which an input to a valuation belongs to one of three levels (i.e., the fair value hierarchy): Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities, Level 2 inputs are directly or indirectly based on observable inputs, and Level 3 inputs are unobservable. An asset or liability is included in its entirety in one of the three levels on the basis of the lowest-level input that is significant to its valuation. Paragraph 57 of the ED proposes that an entity disclose, at a minimum, the following for each class of assets or liabilities measured at fair value:

- The “fair value measurement at the end of the reporting period.”
- The measurement’s level in the fair value hierarchy.
- For assets and liabilities that an entity holds at the end of the reporting period, “transfers between Level 1 and Level 2 . . . and the reasons for those transfers.”
- The “methods and inputs used in the fair value measurement,” including any changes in valuation techniques.
- A reconciliation of the opening and closing fair value of Level 3 assets and liabilities, including separate disclosure of total gains and losses for the period, purchases, sales, issues, settlements, transfers into or out of Level 3, and gains and losses in profit or loss for Level 3 assets and liabilities held at the end of the reporting period.
- The effects of changes in “inputs to reasonably possible alternative assumptions” on Level 3 fair value measurements.

When an entity discloses, but does not subsequently measure, an asset or liability at fair value in the financial statements, the entity should disclose the level of the asset’s or liability’s fair value measurement within the fair value hierarchy.

The ED also includes IFRS 7 disclosures regarding the effect of nonperformance risk on subsequent fair value measurement of a liability.

Finally, paragraph 60 of the ED stipulates that when an “asset is used together with other assets and its highest and best use differs from its current use, an entity shall disclose, by class of asset:

- (a) the value of the assets assuming their current use (ie the amount that would be their fair value if the current use were the highest and best use).
- (b) the amount by which the fair value of the assets differs from their value in their current use (ie the incremental value of the asset group).
- (c) the reasons why the assets are being used in a manner that differs from their highest and best use. ”

## **Effective Date and Transition**

The effective date will be determined upon issuance of a final standard. A final standard would be applied prospectively as of the beginning of the annual period in which it is first applied. Entities would be exempt from providing comparative information in the first period of application.

## Appendix

The following table summarizes the more significant differences between the ED and FASB Statement 157:

Subject	ED	Statement 157
Scope	Applies to leasing arrangements.	Does not apply to leasing arrangements.
Reference market	Assumes that the transaction takes place in the most advantageous market for the asset or liability. The market in which the reporting entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market.	Assumes that the transaction to sell the asset or transfer the liability occurs in the principal market or, in the absence of a principal market, in the most advantageous market for the asset or liability.
Highest and best use	Includes presentation requirements for circumstances in which an entity uses an asset with other assets in a way that differs from the asset's highest and best use.	No similar presentation requirement.
Fair value at initial recognition	Day one differences are recognized in accordance with existing criteria in other IFRSs.	Implicitly requires the recognition of day one profits or losses in some circumstances even if the fair value measurement inputs are unobservable.
Valuation premise	Explicitly states that the in-use valuation premise is not relevant to financial assets.	Not explicitly addressed.
Measurement of liabilities	Proposes a framework in which an entity would use the same method to measure the fair value of a liability as a counterparty uses to measure the fair value of a corresponding asset.	Includes limited guidance on the measurement of liabilities. The FASB has issued a proposed Staff Position (FSP) to clarify the measurement of liabilities at fair value (proposed FSP FAS 157-f); the proposed FSP is largely consistent with the proposals in the ED.
Measurement of equity instruments	Includes a separate discussion for equity instruments measured at fair value. Indicates that fair value is measured from the perspective of a market participant who holds the instrument as an asset.	No separate discussion for equity instruments. Footnote 4 of Statement 157 indicates that the definition of fair value should be applied to equity instruments measured at fair value.
Market participant	Is defined as "knowledgeable, i.e. they are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability."	Is defined as "knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary."

In addition, the ED proposes that an entity disclose the following (these disclosures are not required by Statement 157):

- "Significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers."
- For Level 3 fair value measurements, changes in one or more of the inputs to "reasonably possible alternative assumptions" that significantly affect fair value, and the effects of those changes.
- Fair value, by level within the fair value hierarchy, "for each class of assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed."
- Certain disclosures "for each class of liability measured at fair value after initial recognition." This requirement incorporates certain existing disclosure requirements from IFRS 7.
- Certain disclosures when "an asset is used together with other assets and its highest and best use differs from its current use."

Further, note that Statement 157's disclosure requirements apply to both interim and annual reports, while the ED does not require specific disclosures for interim periods. Instead, the ED proposes amending IAS 34, *Interim Reporting*, to require disclosures about the fair value of financial instruments in interim financial statements. No interim disclosures would be required for nonfinancial assets and liabilities.

In addition, under Statement 157, an entity is required to provide different disclosures for recurring fair value measurements than it does for nonrecurring fair value measurements. The ED does not distinguish between recurring and nonrecurring fair value measurement disclosures.

**Editor's Note:** The IASB staff expects to post to its [Web site](#) a marked version showing differences between the ED and Statement 157 in mid-July 2009. In addition, note that fair value measurement disclosures are also the subject of a current FASB project, "FAS 157 — Improving Disclosures About Fair Value Measurements."

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