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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 May 2006, London**

Project: **Fair Value Measurements (Agenda Paper 8C)**

Unit of Account and Principal vs. Most-Advantageous Markets

BACKGROUND

1 The Board tentatively concluded during their December 2005 meeting that the definition of fair value that is used in the October working draft of the FASB's FVM statement should be accepted as the revised IFRS definition of fair value. As discussed in Agenda Paper 8A, this definition was revised, in part, to eliminate use of the defined term "reference market". However, as it is sometimes possible to sell assets and transfer liabilities in more than one market, it is important to provide guidance that will assist preparers in determining to which market they should refer when measuring fair value. Additionally, during the discussion in the December IASB meeting some Board members expressed confusion regarding how the concepts of the principal market, the most advantageous market and unit of account relate to each other.

2 This paper is organized into two parts. The first part discusses the determination of the unit of account and the order of determining the unit of account and the principal or most advantageous market. The second part discusses which market an entity should refer to when measuring the fair value

of an asset or liability. In both parts the Staff agrees with the positions in the working draft of the FASB's FVM statement (draft FVM statement).

UNIT OF ACCOUNT AND FAIR VALUE MEASUREMENTS

3 The discussion in the draft FVM statement has been reordered from the October working draft to more closely follow the logical progression a preparer would follow in measuring the fair value of an asset or liability. This progression in applying the draft FVM statement is as follows:

(a) First, another pronouncement requires an asset or liability to be measured at fair value, assuming the other pronouncement is within the scope of the fair value measurements statement (paragraphs 1 through 4 of the draft FVM statement);

(b) The measurement objective is established through the definition of fair value (paragraph 5 of the draft FVM statement);

(c) The preparer determines the unit of account, which is the level the asset or liability measured at fair value is aggregated or disaggregated. This determination is made based on the guidance in the standard that is requiring the fair value measurement (paragraph 6 of the draft FVM statement);

(d) The price in the appropriate market is determined as if a transaction were to occur with market participants on the measurement date (paragraphs 7 through 12 of the draft FVM statement)

4 As such, the question of "which market" can only be determined once the unit of account has been established. Paragraph 6 of the draft FVM statement discusses the unit of account:

> "A fair value measurement is for a particular asset or liability, considering factors specific to the asset or liability, including its condition and/or location at the measurement date. In some cases, the asset or liability measured at fair value might be a standalone asset or

> liability, for example, a financial instrument, a nonfinancial asset that is separable from other assets, or a performance obligation. In other cases, the asset or liability measured at fair value might be a group of assets and/or liabilities, for example, a nonfinancial asset that is not separable from other assets, a reporting unit, or a business. Whether the asset or liability measured at fair value is a standalone asset or liability or a group of assets and/or liabilities depends on its unit of account. The unit of account refers to the level at which the asset or liability measured at fair value is aggregated (or disaggregated) for purposes of applying other applicable accounting pronouncements. (Except as provided in paragraph 28, the unit of account for an asset or liability measured at fair value should be determined in accordance with the provisions of other applicable accounting pronouncements.)"

5 With the exception of blocks of financial instruments (paragraph 28 of the draft FVM statement) the FASB decided not to discuss unit of account within the FVM statement because the unit of account in US GAAP differs from one circumstance to another. This is also the case in IFRS where in some circumstances the unit of account is defined as a group of assets, and in others it is defined as a single instrument.

(a) For example, paragraph 66 of IAS 36 states:

> "If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit)."

(b) By comparison, paragraph AG72 of IAS 39 states:

> "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 markets exist for its

component parts, fair value is determined on the basis of the relevant market prices for the component parts."

6 As noted above, the draft FVM statement provides guidance on the unit of account in one exception. Paragraph 28 of the draft FVM statement indicates that if the reporting entity holds a large position of financial instruments (a block) and the instruments are traded in an active market, the fair value of the block shall be measured as the product of the quoted price times the number of units held. In other words, the entity is precluded from recording a blockage factor. This is consistent with AG72 of IAS 39 cited above. This guidance was included in the draft FVM statement because of inconsistencies within US GAAP pronouncements that the FASB decided to resolve.

Staff Recommendation:

7 The Staff does not consider it appropriate or practical to provide detailed guidance on the unit of account within the FVM project. Determining the appropriate unit of account is a critical element of accounting and is not always consistent from one asset or liability to another or from one type of transaction to another. The Staff believes the appropriate unit of account can only be determined in conjunction with a robust discussion of an individual type of asset, liability or transaction. Therefore, the Staff recommends the Board not define or address unit of account within the FVM project. Further, the Staff concludes the guidance in paragraph 28 of the draft FVM statement is not necessary for the IFRS exposure draft. While the guidance in paragraph 28 is consistent with IAS 39, IFRS does not have the same issues as US GAAP with inconsistencies in existing guidance. However, the previous decision of the Board was to expose the FASB's final FVM statement without wording changes. Additionally, the Staff is concerned that if the guidance in paragraph 28 were removed from the IFRS exposure draft some constituents might interpret this as a difference of opinion between the IASB and the FASB. For these reasons the Staff recommends the guidance in paragraph 28 of the draft FVM statement be retained in the IFRS exposure draft.

DETERMINATION OF WHICH MARKET

8 In many circumstances, once the unit of account is determined the exit market to which the reporting entity should refer becomes intuitive. For example, if a cash generating unit is an operating facility such as a manufacturing plant, there would seem to be two possible ways to determine fair value and the fair value would be the higher of these two measurements:

(a) an "in-exchange" fair value (ie, a scrap market for the machinery and a real estate market for the property); or

(b) an "in-use" fair value where a prospective buyer would continue operate the cash generating unit in a similar construct in order to generate cash flow.

9 In either case, there is likely only one market available for each valuation scenario. If measuring fair value “in exchange”, there would likely be one market for the real estate, one market for used machinery and one market for any remaining scrap. If measuring the fair value “in-use”, there is likely one market comprised of strategic and financial buyers that would continue to operate the cash generating unit in its current (or similar) construct.

10 However, for more fungible assets and liabilities an entity might be able to choose from more than one market. This is often true of commodities, certain agricultural assets, and some financial instruments. In such instances an entity must determine which market the fair value measurement should be based. Two views have emerged as possible ways to identify the appropriate market:

(a) the “most advantageous market” view expressed in IFRS and in the June 2004 FASB FVM exposure draft, or

(b) the “principal market” view in paragraph 8 of the draft FVM statement.

Most Advantageous Market

11 Paragraph 16 of the June 2004 FASB FVM exposure draft states:

> “If the entity has immediate access to multiple active markets with different prices, the Level 1 reference market is the most advantageous market, that is, the market with the price that maximizes (or minimizes) the net amount that would be received (or incurred) in a current transaction for an asset (or liability). For purposes of determining the most advantageous market, costs to transact in the respective markets shall be considered.”

12 Paragraph C46 of the June 2004 FASB FVM exposure draft noted the “most advantageous” approach was reasonable based on the assumption that the ultimate goal of most entities is to maximize profits or net assets. Further, the most advantageous approach embodies both the buying and selling side of rational market behaviour and is consistent with normal profit motivation. As such, supporters of the “most advantageous” view argue that a market

participant will seek to maximise the net amount received, and thus will seek to find the most advantageous market. Therefore, if the fair value measurement objective is to estimate current market price, supporters of the "most advantageous" view assert it is appropriate to define the reference market as the market that will maximise the net amount that would be received by the entity.

13 Currently, IFRS guidance tends to adopt the "most advantageous" view. This concept is discussed in IAS 39, IAS 40 and IAS 41. Paragraph AG 71 of IAS 39 states "The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the balance sheet date in that instrument (ie without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access."

14 Paragraph 29 of IAS 40 states:

> "Fair value is measured as the most probable price reasonably obtainable in the market at the balance sheet date in keeping with the fair value definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale."

15 The basis of conclusion to IAS 41 is less clear on the principle. B31 states:

> "When an enterprise has access to different markets, the Standard indicates that the enterprise uses the most relevant one. For example, if an enterprise has access to two active markets, it uses the price existing in the market expected to be used. Some believe that the most advantageous price in the accessible markets should be used. The Standard reflects the view that the most relevant measurement results from using the market expected to be used."

Principal Market

16 In the June 2004 FVM exposure draft, the FASB asked respondents to provide their views on "the most advantageous" view of a reference market. A number of respondents commented that they believe the requirement to consider how many markets an entity has access to and then determine which one is most advantageous is overly burdensome and provides and operational challenge for some types of entities. Further, some respondents elaborated that applying a "most advantageous" view would require continual evaluation of secondary markets to determine whether quoted prices for identical assets are more advantageous, which would require significant changes to pricing systems and vendor contracts in order to accommodate a constant "toggling" between markets. Finally, some noted it would seem reasonable to presume, as a practical matter, that the principal market in which an entity actually transacts would be the most advantageous market, consistent with rational economic behaviour.

17 In response, the FASB affirmed that it was not its intent to prioritize prices in most advantageous markets over prices in principal markets in any cases. The FASB agreed that it would be reasonable to presume that the principal market for an asset or liability will represent the most advantageous market for the asset or liability, as evidenced by the volume and level of activity for the asset or liability in that market. Therefore, the FASB decided the "principal market" view would be more appropriate than the "most advantageous" view. The FASB concluded the most advantageous market should only be considered in circumstances where no single market represents a principal market. Paragraph 8 of the draft FVM statement now states:

> "A fair value measurement assumes an orderly transaction between market participants in the principal market for the asset or liability or, if there are multiple markets for the asset or liability with different prices and no single market represents a principal market, in the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability with the greatest level of activity for the asset or liability. The most advantageous market is the market in which the

reporting entity would sell or otherwise dispose of the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability. Because different entities with different business activities transact in different markets, the principal (or most advantageous) market is considered from the perspective of the reporting entity (the entity that holds the asset or liability)."

Staff Analysis

18 The Staff reasons that in many instances the most advantageous market will also be the principal market for a given asset or liability. However, there may be instances where the principal market might not be the most advantageous market on a given date. The Staff reasons the market on which an asset or liability is principally traded provides a more liquid, and therefore more representative price. Further, the Staff asserts that any material pricing differences that are not illusory would be arbitraged by market participants until equilibrium was established. If a market did consistently provide a more advantageous price, market participants would gravitate to the market, eventually making it the principal market. Finally, the Staff reasons that fair value might be distorted by a "most advantageous" approach if an unusual transaction on a less liquid market artificially inflated or deflated the quoted price.

19 The Staff also observes the guidance in the draft FVM statement requires both the principal market and the most advantageous market be determined from the perspective of the reporting entity that holds the asset or liability. While some might consider this to be contrary to market objective of fair value, the Staff reasons this guidance is appropriate because it makes the fair value measurement relevant to the financial statements of the reporting entity. The Staff asserts a fair value measurement based on a market that is neither the principle market nor the most advantageous market from the perspective of the reporting entity is not a relevant measure of fair value for the financial statements of the reporting entity.

<u>Staff Recommendation</u>

20 The Staff agrees with the FASB's conclusion and recommends adopting the "principal market" view. While this will result in a change from the "most advantageous" view currently in IFRS, the Staff reasons the "principal market" view more accurately reflects the fair value measurement objective and provides a more representation measure of fair value by giving preference to highly liquid markets over less liquid markets. Additionally, while the Staff agrees with the conclusions reached by the FASB, there is one additional considerations the Staff would like to highlight for Board comment.

Consideration of transaction costs when determining the most advantageous market

21 As noted above, the guidance in paragraph 8 of the draft FVM statement states: "The most advantageous market is the market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability with the price *that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability*." *[emphasis added]*

22 The word "amount" is intentionally used as opposed to price to indicate the entity should consider the net amount that would be received after the transaction (including transaction related costs). For purposes of determining the most advantageous market for the asset or liability, the price in the respective markets shall include transaction costs (the incremental direct costs to transact in that market) and/or transportation costs (the costs to access that market). In the Staff's view, this reflects normal profit motivations where an entity, when choosing the most advantageous market, would most certainly consider the costs associated with transacting in that market. As such, the Staff agrees with this position. However, the Staff is concerned constituents might not notice the use of the word "amount" and might not appreciate the intentions of its use. As such, the Staff believes this additional guidance or discussion would be appropriate in the statement or implementation guidance.

23 Transaction costs and transportation costs in measuring fair value are discussed in Agenda Paper 8F. However, the Staff seeks the Board's views on the matter on whether transaction and transportation costs should be considered when determining the most advantageous market. Further, the Staff seeks the Board's

views on whether the current discussion in the draft FVM statement sufficiently highlights this matter.