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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

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

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

Comparison of Draft Fair Value Measurement Statement to AcSB staff Discussion Paper on Measurement on Initial Recognition

Summary

1 This paper provides a summary of the conceptual differences between the working draft of the FASB's Fair Value Measurements statement (draft FVM statement) and the Discussion Paper on Measurement on Initial Recognition prepared by the staff of the AcSB (DP). This paper only discusses the key conceptual differences and is not an attempt to provide a comprehensive listing of all differences between the two documents.

Key Conceptual Differences

<u>*Scope*</u>

2 The objective of the DP was to develop a conceptual framework for measurement, focusing on the relevance and reliability of possible measurement bases (including but not limited to fair value) at initial recognition. Issues of remeasurements are beyond the scope of the DP. Further, the DP does not seek

to codify or harmonize fair value measurement guidance based on existing fair value requirements in IFRS.

3 In comparison, the draft FVM statement does not discuss when fair value is or is not appropriate. Rather, the draft FVM statement seeks to codify and simplify existing guidance on fair value measurements in order to establish a single, consistent measurement objective when a fair value measure is required by another standard.

Reliability Threshold

4 The DP asserts the objective of fair value is to reliably represent the market value of an asset or liability on a measurement date. The DP reasons this market value concept is what makes a fair value measurement relevant, and provides a frame of reference for judging whether particular measurements are faithful (reliable) representations of fair value. The DP defines a market as "a body of knowledgeable, willing, arm's length parties carrying out sufficiently extensive transactions in an asset or liability to achieve its equilibrium price, reflecting the market expectation of earning or paying the market rate of return for commensurate risk on the measurement date." Accordingly, the DP proposes that the objective of fair value is to reflect the value that would result from such a market.

5 Level 1 and 2 of DP hierarchy are based on the use of observable market prices or valuation models or techniques where all significant inputs are observable in the market. In circumstances where Level 1 or 2 measurements are not possible, the DP concludes a reliable estimate of fair value cannot be made. In such cases, the DP proposes that a reliable alternative measurement basis be used. The DP reasons that these could include current cost[1] (Level 3 of the DP hierarchy), or models or valuation techniques based on entity inputs which are not demonstrably inconsistent with observable market expectations (Level 4 of the DP hierarchy). The DP reasons current cost measures or valuation models or techniques based on entity inputs cannot be relied upon to result in values that reflect the essential properties of market values as defined. As such, the DP

[1] The DP proposes that current cost be interpreted to be a replacement cost when reliably measurable, or if not, reproduction cost. For practical purposes, historical cost measurement may often be acceptable in lieu of current cost on initial measurement.

proposes that such less relevant measurements are substitutes for fair values on which financial statement users should be informed.

6 In comparison, the draft FVM statement indicates the fair value measurement objective is to determine the price that would be received for an asset or paid to transfer a liability in a transaction between two or more market participants at the measurement date. In circumstances where market observable inputs are not available, an entity should estimate market inputs to the best of their ability. However, even when using unobservable inputs, the objective remains the same. The draft FVM statement does not include a reliability threshold for a fair value measure. Rather, the FASB concluded that concerns about fair value measurements that are predicated on hypothetical transactions in hypothetical markets derive from a threshold issue that relates principally to the selection of the appropriate measurement attribute. The FASB noted this is an important area of focus in the conceptual framework project. Further, the FASB noted they plan to continue to address the issue of which measurement attribute should be required in individual accounting pronouncements on a project-by-project basis.

Entry-exit values

7 The DP defines fair value in terms of its market exchange price, which is the entry price to the buyer and the exit price to the seller in that market. The DP asserts this reflects the economic attributes of an asset or liability because such fair values represent the market's estimates of the values of the future cash inflows/outflows associated with the asset or liability traded in that market. The DP reasons that whether a particular market is an "exit" or "entry" market depends on the entity's position in relation to that market, i.e., is a characteristic of the entity rather than being an attribute of the asset or liability. The DP concludes that the fair value on the initial recognition of an asset or liability will often be most reliably measured on the basis of the market in which the asset or liability is acquired or issued. The DP reasons that jumping to an exit market in such cases will likely give rise to additional re-measurement issues. Re-measurement recognition issues are beyond the scope of the DP.

8 The draft FVM statement considers fair value to be an exit price in the principal market for the asset or liability. If no single market represents a principal market, the fair value measurement should represent the exit price in the most advantageous market. In either case, the principal or most advantageous market is determined from the perspective of the entity that holds the asset or owes the liability. The FASB concluded that an exit price objective is appropriate because it provides a direct measure of the market's estimate of the future inflows associated with the asset and the future outflows associated with the liability, consistent with the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements.

Transaction price

9 The DP reasons that the fact that an arm's-length price has been paid or received by the reporting entity to acquire an asset or assume a liability is not sufficient evidence of market value in and of itself (because a single transaction is not a market). The DP proposes that additional persuasive evidence of market value should be obtained to be in a position to determine whether the transaction price equalled the fair value of the asset or liability on the transaction date. (For practical purposes, such evidence might be reasonably presumed for items that are regularly traded in open markets, but may not exist for unique assets or liabilities.)

10 The FASB reasoned a transaction price represents the price paid for the asset or received to assume the liability (an entry price) is conceptually different than the fair value of the asset or liability represents the price that would be received for the asset or paid to transfer the liability (an exit price in the draft FVM statement). As such, the draft FVM statement concludes that in many cases a transaction price will represent the fair value of an asset or liability at initial recognition, but not presumptively. Therefore, the FVM statement requires the reporting entity to consider factors specific to the transaction and the asset or liability in determining whether a transaction price represents the fair value of the asset or liability at initial recognition.

Multiple markets

11 If two (or more) markets (actual or hypothetical) do exist that yield reliable different values for an asset or liability on a measurement date, the DP concludes fair value would be measured at the price in the most advantageous accessible "market" from the perspective of the reporting entity. However, the DP might view these as re-measurements requiring that some additional recognition conditions be met. Further, re-measurement is beyond the scope of the DP.

12 The draft FVM statement concludes a fair value measurement assumes an orderly transaction between market participants in the principal market for the asset or liability. The draft FVM statement indicates 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 volume and level of activity for the asset or liability. If there are multiple markets for the asset or liability with different prices and no single market represents a principal market, the fair value measurement assumes an orderly transaction in the most advantageous market for the asset or liability. The most advantageous market is the market that maximises the amount that would be received for the asset or that would be paid to transfer the liability. In either case, the appropriate market is considered from the perspective of the reporting entity (seller) that holds the asset or liability, thereby allowing for differences between and among entities and the markets in which those entities transact.

The "in-use" valuation premise

13 The DP proposes that the market value will reflect the market's expectation of the highest and best use of an asset. The DP accepts that an "in-exchange" price that does not reflect the in-use properties of an asset (and thus may result in it being measured at, for example, its scrap value) is not a faithful representation of its fair value. But the DP questions how an estimate of its in-use value could avoid being an arbitrary allocation of the estimated fair value of its cash-generating unit or, alternatively, being an estimate of its replacement cost which must be heavily dependent on entity inputs. Application of the DP hierarchy could result in many unique use assets being measured at their current cost (for which historical cost would often be an acceptable substitute on initial

recognition). The DP would consider such a cost measurement as a substitute for, rather than an estimate of, fair value.

14 The draft FVM statement indicates a fair value measurement for an asset assumes the highest and best use of the asset from the perspective of market participants. In broad terms, highest and best use refers to the use of an asset by some (two or more) market participants that would maximize the fair value of the asset in a hypothetical transaction to sell or otherwise dispose of the asset at the measurement date, and is determined without regard to the intended use of the asset by the reporting entity. If the highest and best use of an asset is "in-use", the asset is not separable or substitutable with other equivalent assets (the hypothetical transaction between market participants to sell or otherwise dispose of the asset at the measurement date involves an asset group that is in-use). As such, the fair value measurement might require allocation to the assets and liabilities included in an asset group. The draft FVM statement does not discuss allocation of the measurement to the components of an asset group. Rather, the draft FVM statement leaves the issue of allocation to be considered in the specific standard requiring the fair value measure.

Multiple Valuation Techniques

15 The DP does not rule out the application of multiple valuation techniques for estimating fair value. However, methods like the cost approach (current replacement cost) would likely be considered a substitute for fair value on initial recognition when fair value cannot be reliably estimated. Further, the DP reasons that present value techniques cannot be justified to represent fair value if they are significantly dependent on entity inputs that cannot be corroborated by market evidence.

16 The draft FVM statement requires valuation techniques used to estimate fair value be consistent with the market approach, income approach, and cost (or asset-based) approach. When using the cost approach, from the perspective of a market participant (seller), the measurement assumes that the price that would be received for the asset would not exceed the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Additionally, the draft FVM statement states in some cases, a

single valuation technique will be appropriate. In other cases, multiple valuation techniques will be appropriate. The draft FVM statement indicates when multiple valuation techniques are used to estimate fair value, the results (respective indications of fair value) shall be evaluated and considered, as appropriate, in determining the single estimate of fair value.

Blocks

17 The DP holds that the quantity or volume of an asset acquired can affect its fair value on initial recognition. For example, if an entity acquired a large block of a security at a discount from the quoted market price for smaller blocks regularly traded on an exchange, the DP argues that it is not conceptually correct to write the acquired shares up on initial recognition to reflect the quoted market price for smaller blocks of the security - but that the block factor should be taken into account. In this example, the DP would recognize the unit of account to be the block on initial recognition, since the block was acquired. It suggests that a change in the unit of account from that existing on initial recognition should be considered to be a re-measurement issue, which would require addressing re-measurement recognition issues beyond the scope of the DP. There may well be difficulties in reliably estimating the market block effect in some situations, but that does not affect the principle.

18 The draft FVM statement concludes fair value for a large position of a financial instrument (block) that is traded in an active market shall be measured as the product of the quoted price for an individual trading unit times the quantity held. As such, the quoted price shall not be adjusted by a blockage factor, that is, a discount (or premium) based on the size of the block relative to trading volume, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the block in a single transaction might affect the quoted price.