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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 8B)**

Revised Fair Value Hierarchy

OVERVIEW OF THIS PAPER

1 In this paper the Staff compares the three-level hierarchy in the current working draft of the FASB's Fair Value Measurements statement (draft FVM statement) to current guidance in IFRS.

2 The Staff concludes the revised hierarchy in the draft FVM statement is consistent with the principles and definition of fair value discussed in Agenda Paper 8A. The Staff concludes the revised hierarchy in the draft FVM statement is an improvement over the disparate and inconsistent guidance currently in IFRS. Based on this conclusions, the Staff recommends adopting the three-level hierarchy in the draft FVM statement.

REVISED FAIR VALUE MEASUREMENT HIERARCHY

3 The draft FVM statement indicates valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs. The hierarchy prioritizes the inputs to valuation

techniques used to measure fair value based on their observable or unobservable nature.

4 The October working draft of the FASB's FVM statement contained a five level hierarchy for inputs used in measuring fair value. Some reviewers questioned the ordering of and differentiation between inputs in levels 2 through 4 of the hierarchy. In deliberating comments from reviewers, the FASB staff observed that levels 2 through 4 were originally added to clarify the types of market inputs that should be used to measure fair value without prescribing the ordering of those inputs because the market inputs used to measure fair value will vary depending on the circumstances. The FASB agreed with the staff observations and decided to maintain all existing guidance in levels 2 through 4 of the hierarchy, but to condense levels 2 through 4 to a single level.

5 The FASB also decided to emphasise the market objective of a fair value measurement. In particular the FASB clarified the wording in the lowest level of the hierarchy to specify that a level 3 input is an "unobservable market" input rather than an "entity" input. This was done to clarify that even in circumstances where an input is not observable the measurement objective remains the same – inputs should reflect market views and should be adjusted to exclude any entity specific views that are inconsistent with the market's expectation.

6 These decisions resulted in the revised three-level hierarchy in the draft FVM statement (paragraphs 25 to 31 of the draft FVM statement). The revised three level hierarchy is summarised as follows:

(a) Level 1 inputs are observable inputs that reflect quoted prices for identical assets or liabilities in active markets the reporting entity has the ability to access at the measurement date.

(b) Level 2 inputs are observable inputs other than quoted prices for identical assets or liabilities in active markets at the measurement date.

(c) Level 3 inputs are unobservable inputs, for example, inputs derived through extrapolation or interpolation that cannot be corroborated by observable data. However, the fair value measurement objective remains the same. Therefore, unobservable inputs should be adjusted for entity information that is inconsistent with market expectations. Unobservable inputs should also consider the risk premium a market participant (buyer) would demand to assume the inherent uncertainty in the unobservable input.

EXISTING GUIDANCE IN IFRS

7 IFRS currently does not have a single hierarchy that applies to all fair value measures. Instead individual standards indicate preferences for certain inputs and measures of fair value over others, but this guidance is not consistent among all IFRSs. For example:

IAS 36 – *Impairment of Assets*

(a) In measuring fair value less costs to sell, paragraph 25 through 27 establish the following hierarchy:

(i) Paragraph 25 states "The best evidence of an asset's fair value less costs to sell is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset."

(ii) Paragraph 26 continues "If there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal."

(iii) Finally, paragraph 27 states "If there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at the balance sheet date, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal."

IAS 39 – *Financial Instruments: Recognition and Measurement*

(b) Paragraph 48A discusses fair value considerations and establishes the following hierarchy:

(i) "The best evidence of fair value is quoted prices in an active market."

(ii) "If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. 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. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair 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. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments."

IAS 41 – *Agriculture*

(c) In contrast to IAS 36, IAS 41 states in paragraph 16 that "Contract prices are not necessarily relevant in determining fair value, because fair value reflects the current market in which a willing buyer and seller would enter into a transaction. As a result, the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract."

(d) Paragraphs 17 to 25 continue to establish the following hierarchy:

(i) Paragraph 17 states “If an active market exists for a biological asset or agricultural produce, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an entity has access to different active markets, the entity uses the most relevant one.”

(ii) Paragraph 18 continues “If an active market does not exist, an entity uses one or more of the following, when available, in determining fair value:

(A) the most recent market transaction price, provided that there has not been a significant change in economic circumstances between the date of that transaction and the balance sheet date;

(B) market prices for similar assets with adjustment to reflect differences; and

(C) sector benchmarks such as the value of an orchard expressed per export tray, bushel, or hectare, and the value of cattle expressed per kilogram of meat.”

(iii) Paragraph 20 continues “In some circumstances, market-determined prices or values may not be available for a biological asset in its present condition. In these circumstances, an entity uses the present value of expected net cash flows from the asset discounted at a current market-determined pre-tax rate in determining fair value.

(iv) Finally, paragraph 24 indicates that cost may sometimes approximate fair value, particularly when little biological transformation has taken place since initial cost incurrence or when the impact of the biological transformation on price is not expected to be material.

8 Other standards providing limited “hierarchy” guidance include:

(a) IAS 16 – *Property, Plant and Equipment* - In discussing the revaluation model, IAS 16 indicates in paragraph 32 the fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal. Paragraph 33 states if there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

(b) IAS 38 – *Intangible Assets,* states in paragraph 39 that "quoted market prices in an active market provide the most reliable estimate of the fair value of an intangible asset." Paragraph 40 continues "if no active market exists for an intangible asset, its fair value is the amount that the entity would have paid for the asset, at the acquisition date, in an arm's length transaction between knowledgeable and willing parties, on the basis of the best information available." Finally, paragraph 41 indicates an entity may use a valuation technique to measure the fair value of an intangible asset acquired in a business combination.

(c) IAS 40 – *Investment Property* - paragraph 45 to 48 of IAS 40 establish a hierarchy that is generally consistent with the hierarchy IAS 16 discussed above.

9 The Staff asserts the discrepancies in the above hierarchies add unnecessary complexity to IFRS. Further, inconsistent guidance on from standard to standard increases the risk of inconsistent application among preparers.

COMPARISON OF THE DRAFT FVM STATEMENT TO EXISTING IFRS

10 The Staff observes there are some similarities between the revised hierarchy in the draft FVM statement in comparison to the various hierarchies in IFRS. Generally, both the various IFRS hierarchies and the draft FVM statement

hierarchy give preference to observable market inputs over unobservable market inputs. However, not all standards that require a fair value measurement include guidance on the hierarchy that should be applied. This requires an entity to look to another standard for guidance. The Staff assets different entities might look to different standards for such guidance, thus potentially causing inconsistency in practice. As such, the Staff reasons a single, consistently applied hierarchy would significantly reduce complexity of fair value measures in IFRS.

11 The Staff acknowledges some might not consider a measurement based on Level 3 inputs to be an appropriate measure of fair value. This position is generally consistent with certain conclusions reached in the discussion paper on Measurement on Initial Recognition prepared by the staff of the Canadian Accounting Standards Board, which proposes: "A measurement model cannot be considered to achieve a reliable estimation of the fair value of an asset or liability if it depends significantly on entity-specific expectations that cannot be demonstrated to reliably represent market expectations (paragraph 267)." *Please note – for the purposes of this discussion, the Staff considers "entity-specific expectations" in the Canadian paper to be analogous to "unobservable market inputs" in the FASB's draft FVM statement.*

12 However, the Staff notes that the IASB has previously concluded in certain circumstances that measures based on unobservable data can represent a fair value measurement and that these measures are appropriate for recognition in the financial statements. For example, IAS 39 does not provide a reliability exception or recognition threshold for derivative instruments, even if significant inputs to the fair value measurement are unobservable market inputs. For this reason the Staff concluded that unobservable market inputs are not inconsistent with a fair value measurement objective, so long as any the inputs are not inconsistent with market expectations. Rather, the Staff asserts questions of reliability, relevance and representational faithfulness should be considered when determining the appropriate measurement attribute for a particular asset, liability or transaction.

Staff Recommendation

13 The Staff concludes the revised hierarchy in the draft FVM statement is consistent with the principles discussed in Agenda Paper 8A. Further, the Staff concludes the hierarchy in the draft FVM statement represents an improvement over the disparate and inconsistent guidance current in IFRS. As such, the Staff recommends the three-level hierarchy in the draft FVM statement.

14 Does the Board agree with the Staff recommendation?