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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 8D)**

Transaction Price Presumption

SUMMARY

1 At the December meeting, the IASB tentatively agreed the fair value measurement objective was an exit price. The December discussion highlighted the conceptual difference between transaction price (what an entity would pay to buy an asset or receive to assume a liability) and an exit price objective (what an entity would receive to sell an asset or pay to transfer a liability).

2 Entities often buy assets or acquire liabilities in at different prices than they sell assets or transfer liabilities. As such, the Staff reasons a transaction price to acquire an asset or assume a liability (an entry price) is conceptually different with the fair value measurement objective in the draft FVM statement (an exit price). Based on this reasoning, this paper discusses whether an entity can presume a transaction price to equal fair value on initial measurement. Please note this paper does not discuss *recognition* of day-one gains. The Staff plans to bring a separate discussion of day-one gains and losses to the Board in a future meeting.

3 The Staff concludes that an entity cannot presume an entry price to be equal to an exit price without considering factors specific to the transaction and the asset or liability. As such, the Staff recommends the guidance in paragraphs 17 and 18 of the current working draft of the FASB's Fair Value Measurements statement (draft FVM statement). The Staff seeks the Board views on this recommendation.

BACKGROUND

4 In the December 2005 IASB meeting, the Board tentatively agreed with the Staff recommendation that fair value is an exit price (please refer to Agenda Paper 6A of the December 2005 IASB meeting). Further, the Staff asserted in Agenda Paper 8A of this meeting that an exit price objective of fair value is appropriate because it provides a measure of expected inflows associated with an asset or outflows associated with a liability that is independent from the entity and is consistent with the definition of assets and liabilities in the Framework.

5 The Staff observes entities often sell assets or transfer liabilities at different prices than they acquire assets or assume liabilities. Therefore, in some circumstances, fair value (an exit price) will differ from the transaction price (an entry price). Can an entity presume the transaction price represents fair value on initial measurement? Or, should an entity consider factors specific to the transaction and the asset or liability first? Further, what sort of factors should an entity consider when assessing if the transaction price represents fair value on initial recognition?

CURRENT IFRS GUIDANCE

6 IFRS requires few items be recorded at fair value on initial recognition. There is limited guidance in IFRS on whether the transaction price is presumptively fair value on initial recognition. Guidance is limited to financial instruments in IAS 39 and IFRS 7 and to agricultural assets in IAS 41. The guidance in these standards is not consistent as to whether the transaction price is considered the best evidence of fair value on initial recognition. For example:

(a) IAS 39 and IFRS 7 explicitly state the transaction price is the best evidence of fair value on initial recognition:

   (i) Paragraph AG64 of IAS 39 states: "The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG74–AG79)."

   (ii) Paragraph AG76 of IAS 39 states: "The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets."

   (iii) Paragraph 28 of IFRS 7 states: "If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG74–AG79 of IAS 39). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (ie the fair value of the consideration given or received), unless conditions described in paragraph AG76 of IAS 39 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique."

(b) In comparison, paragraph 18a of IAS 41 reverts to a transaction price only if an active market does not exist, thus giving priority to the market measure over the transaction price.

FASB DRAFT FVM STATEMENT

7 The October 2005 working draft of the Fair Value Measurements statement began with a position that was generally consistent with IAS 39. Paragraph 15 of the October working draft stated "in a transaction in which the entity acquires an asset or assumes a liability, the transaction price is presumed to represent the fair value of the asset or liability at initial recognition, absent persuasive evidence to the contrary." Paragraph 15a. and 15b. illustrated instances where this presumption might be rebutted:

(a) 15a – "The transaction is between related parties or occurs under duress where the seller is experiencing severe financial difficulties, such as bankruptcy or other financial pressures, or is forced to accept the price in the transaction because of urgency."

(b) 15b – "The market in which the transaction occurs is not the reference market for the asset or liability (the entity would transact in a more advantageous market for the asset or liability). In that case, the fair value of the asset or liability to the entity would be based on the price in the reference market for the asset or liability. (If the counterparty would not transact in a more advantageous market, the fair value of the asset or liability to the counterparty would be based on the price in the market in which the transaction occurs, that is, the transaction price.)"

8 Some reviewers of the October working draft expressed confusion regarding how the transaction price and fair value measurement relate, and the presumption they are the same at initial measurement. They indicated that the guidance was ambiguous with respect to when a price in a transaction that involves the reporting entity versus an observed price within the fair value hierarchy (a price in a transaction that does not involve the reporting entity) should be used to measure the fair value of an asset or liability at initial recognition. Additionally, some reviewers commented that the difference between transaction price and fair value might not only be limited to circumstances in which entities acquire assets or assume liabilities in a different market than they sell assets or transfer liabilities.

9 Upon reconsideration, the FASB decided to emphasise the exit price objective of fair value. The FASB concluded in many cases, a transaction price will represent the fair value of an asset or liability at initial recognition, but not presumptively. The FASB further decided to provide an illustrative list of factors an entity should consider when assessing if the transaction price represents fair value.

10 The FASB decided to highlight four situations where a transaction price would likely differ from a fair value measurement. This list is included in paragraph 18, items a) though d) of the current draft FVM statement, however, the list is not meant to be all-inclusive.

(a) The transaction is with related parties. In some instances and in some jurisdictions, related party transactions are required to be at an arm's length price. In fact, in some jurisdictions fairness opinions are required to document the sale of certain assets between related parties were at a market price. However, this is not always the case. When such legal requirements do not exist, transactions between related parties will usually not go through an active bid process. Additionally, often one related party is able to exert influence over the other party, thus causing the transaction to be higher or lower than a market price. As such, circumstances where the transaction is between related parties should be critically analysed to determine the appropriate price if the asset, liability or transaction is required to be measured at fair value.

(b) Transactions that occur under duress or when the seller is forced to accept the price in the transaction because of urgency. In circumstances where one entity is required to transact, for example, in a forced liquidation or when an entity is experiencing financial difficulty, the transaction price is likely to differ from fair value.

(c) Transaction where 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. This is often the case when the transaction price reflects a multiple element arrangement. An example is when the transaction price is for an automobile and a three-year warranty.

(d) Transactions where the market in which the transaction occurs is different from the principle (most advantageous) market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability. For example, a financial institution might have access to both a retail market (comprised of the institution's customers) and a wholesale market (comprised of other dealer entities). In such circumstances, the financial institution might be able to trade the same asset in both markets at different prices without repackaging the asset or liability.

STAFF DISCUSSION

11 The Staff agrees that there are circumstances where a transaction price will not represent fair value. Specifically, the Staff agrees this will often be in cases:

(a) when a transaction is between related parties;

(b) where one party is under duress;

(c) where 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; or

(d) when an entity sells assets or transfers liabilities in different markets than they acquire the assets or liabilities;.

12 The Staff also shares the FASB's view that it is appropriate to emphasise the exit price objective of fair value. As such, the Staff concludes entities should not be able to presume the entry price is equivalent to the exit price without considering the relevant facts and circumstances of the transaction for the asset or liability. Therefore, the Staff agrees with the view that in many cases a transaction price will represent the fair value of an asset or liability at initial recognition, but not presumptively. Finally, the Staff agrees with the FASB conclusion that the factors that may cause the transaction price for a certain asset, liability or type of transaction to differ from fair value on initial

recognition should be considered on a project-by-project basis. As such, the Staff reasons the Board may determine in certain standards that the transaction price should be considered to represent fair value because they were unable to identify circumstances where this presumption would not hold true.

Staff Recommendation

13 The Staff is concerned that if a transaction price were presumed to be fair value on initial measurement entities might not sufficiently consider the differences between an entry transaction price and an exit fair value. As such, the Staff recommends IFRS require an entity to consider factors specific to the transaction and the asset or liability in assessing if the transaction price represents fair value. As such, the Staff also recommends the factors in paragraphs 17a. through 17d. of the draft FVM statement in order to provide illustrative guidance on the types of factors an entity should consider.

14 The Staff seeks the Boards views on these recommendations.