30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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: **19 September 2006, London**

Project: **Fair Value Measurements**

Subject: **Issues in the Invitation to Comment (Agenda Paper 10B)**

Introduction

1 While discussing working drafts of the Invitation to Comment with individual Board members, the following matters were identified which the staff wishes to discuss with the Board:

(a) *Item 1:* Rather than stating a preference for the exit price measurement objective of Fair Value in the FASB's FVM Statement, should we instead discuss two views (one supporting the exit price measurement objective, the other separating fair value into an entry price measurement objective when an asset or liability is measured at fair value at initial recognition and an exit price measurement objective for subsequent fair value measurements)?

(b) *Item 2:* Should we include a discussion and question on the principal and most advantageous markets view in the FASB's FVM Statement and how this generally differs from current IFRSs?

(c) *Item 3:* Should we raise a question asking constituents whether a fair value measurement containing a significant Level 3 input should be labelled something other than 'fair value'?

(d) *Item 4:* Should we include a question as to whether the prohibition of block adjustments should apply to all levels of the fair value hierarchy or only to Level 1?

(e) *Item 5:* Do Board members wish to retain the current discussion of day-one gains and the transaction price presumption? [Sentence omitted from observer note].

(f) *Item 6:* Should we modify (by either deleting or shading) the aspects of the FASB's FVM Statement, its footnotes and appendices that are US GAAP specific (ie, that have no relevance to IFRSs)?

2 These items are discussed separately below. The Staff will request Board members to indicate their preferences to each of the above issues during the September Board meeting. Further, the Staff will ask Board members during the meeting whether they have any additional matters they wish to discuss regarding the FASB's FVM Statement or the draft Invitation to Comment and Discussion Paper. If not, the staff will request permission to begin the pre-ballot and balloting process on the Discussion Paper.

DISCUSSION

Item 1: Entry and exit prices

3 As discussed during the May 2006 meeting, the definition of fair value in the FASB's FVM Statement focuses on the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price), not the price that would be paid to acquire the asset or received to assume the liability at the measurement date (an entry price). During the May meeting, the Board reached a preliminary view that an exit price definition of fair value was appropriate [Sentence omitted from observer note].

4 However, in discussing a draft of the Invitation to Comment for the FVM Discussion Paper, individual Board members questioned whether there might be circumstances when an entry price measurement objective might be more appropriate. Therefore, the staff requests the Board to reconsider their preliminary view that an exit price definition of fair value is appropriate or alternatively to modify or retract this preliminary view for the Invitation to

Comment. As discussed in more detail below, the staff recommends not including a preliminary view in the Invitation to Comment regarding the exit price measurement objective. Rather, the staff recommends the Invitation to Comment discuss two views without stating a preference.

(a) View 1 supports an exit price measurement objective value for all fair value measurements required by IFRSs.

(b) View 2 proposes an entry price measurement objective (as defined below) for situations when IFRSs require fair value on initial measurement and an exit price measurement objective for fair value measurements required subsequent to initial recognition.

5 The FASB's FVM Statement defines fair value as 'the price that would be received to sell and asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.' This is an exit price from the perspective of a market participant that holds the asset or owes the liability. The FASB concluded that an exit price objective is appropriate because it embodies current expectations about the future inflows associated with the asset and the future outflows associated with the liability from the perspective of market participants. The FASB observed that the emphasis on inflows and outflows is consistent with the definitions of assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Paragraph 25 of Concepts Statement 6 defines assets in terms of future economic benefits (future inflows). Paragraph 35 of Concepts Statement 6 defines liabilities in terms of future sacrifices of economic benefits (future outflows).

6 The Board (IASB) observed during its December 2005 meeting that paragraph 49 of the *Framework for the Preparation and Presentation of Financial Statements* similarly defines assets and liabilities in terms of inflows and outflows of economic benefits. Further, a majority of the Board agreed with the staff recommendation that a fair value measurement should reflect market-based estimate of the economic benefits that are expected to flow into or out of the entity, which is an exit price objective. This decision was affirmed by the by the Board during the May 2006 meeting.

7 Since the May meeting, the staff has had discussions with individual Board members, user groups and others questioning if an entry price measurement objective might be more appropriate when an asset or liability is required to be recorded at fair value on initial recognition (view 2 above). For purposes of this discussion, the staff will use exit and entry prices with the following definitions:

(a) An *Exit Price* is the price that would be *received to sell* an asset or *paid to transfer* a liability in an orderly transaction between market participants at the measurement date. [Consistent with the definition of fair value in the FASB's FVM statement.]

(b) An *Entry Price* is the price that would be *paid to acquire* an asset or *received to assume* a liability in an orderly transaction between market participants at the measurement date.

8 The basis for View 2 can be summarised as follows:

(a) Fair value measurements currently required under IFRSs can be categorized into two broad categories: those that require assets or liabilities to be measured at fair value on initial recognition and those that require an asset or liability to be measured at fair value subsequent to initial recognition.

(b) An exit price measurement objective is appropriate for fair value measurements subsequent to initial recognition because such measurements are generally assessing recoverability of an asset or the expected economic outflow of a liability. As noted above, an exit price provides a measure of expected future inflows associated with an asset or outflows associated with a liability that is independent of the entity and is a direct measure of the recoverability of an asset or the expected economic outflow of a liability.

(c) However, the measurement objective at initial recognition is often not recoverability. Rather, the objective is to reflect the characteristics of the asset or liability (exclusive of transaction costs as these are not an attribute of the asset or liability) at the time of the transaction considering the markets in which the reporting entity could acquire the asset or assume the liability. Recoverability of these amounts is assessed separately under the current IFRS accounting model as evidenced by the fact there is separate impairment guidance (such as IAS 36 and paragraphs 58-70 of IAS 39). An entry price measurement best achieves this objective.

9 Some question whether entry prices and exit prices will be the same in most circumstances. If so, they question the benefit of splitting the term 'fair value' into two separate measurement attributes.

10 The staff reasons entry and exit prices *might* differ due to a variety of reasons. As noted in paragraph 16 of the FVM statement, entities do not necessarily sell assets at the prices paid to acquire them. Paragraph 17 of the FVM statement states that an entity should consider factors specific to a transaction and to the asset or liability when assessing if a transaction price represents fair value (with an exit price measurement objective). Paragraph 17 of the FVM statement lists four examples of situations where a transaction price might not represent the exit price of an asset or liability at initial recognition:

(a) If the transaction is between related parties;

(b) If the transaction occurs under duress or the seller is forced to accept the price in the transaction;

(c) If 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) If the market in which the transaction occurs is different from the principal (or most advantageous) market in which the reporting entity would sell the asset or transfer the liability

11 The staff observes items (a) through (c) might cause an observed price in a market to represent neither an entry price nor an exit price. As such, items (a) through (c) should be considered when assessing whether a transaction price represents either an entry price or an exit price.

12 The staff reasons that entry and exit price would most often differ because the market in which an entity buys an asset or assumes a liability differs from the

market in which the entity would sell the asset or transfer the liability. In many situations, an entity may have only one market in which they can both acquire and sell an asset or, conversely, assume and transfer a liability. For example, the Board tentatively concluded that the exit and entry prices for a business in a business combination would presumably be the same because the market in which the business is acquired is presumably the same market in which it would be sold.

13 However, while entry and exit prices may be equal in many situations, the perspectives used to determine each are conceptually different. Therefore, that entry and prices will often be the same amount is not relevant in the staff's opinion. Rather, the staff contends it is important that the concepts be distinguished in order to more clearly communicate the measurement objective. Further, the staff asserts that it is possible that entry and exit prices might differ significantly in situations where entities can transact for identical assets and liabilities in multiple markets (which might be the case for certain financial assets, biological assets and commodities traded in multiple markets).

14 *Staff recommendation:* Based on the above discussion , the staff concludes that the concepts of entry and exit prices needs further consideration before a preliminary view is articulated. Constituent input will be helpful for this discussion. The staff therefore recommends articulating the two views in paragraph 4 without a preliminary Board view. [Sentence omitted from observer note]. Do Board members agree with the staff recommendation?

Item 2: Principal (or most advantageous) market

15 IAS 39 requires an entity to use the most advantageous active market in measuring the fair value of an asset or liability when multiple markets exist whereas IAS 41 requires an entity to use the most relevant market:

(a) IAS 39.AG71 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.'

(b) IAS 41.17 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. For example, if an entity has access to two active markets, it would use the price existing in the market expected to be used.'

16 By comparison, the FASB FVM Statement requires an entity use the principal market for the asset or liability. In the absence of a principal market for the asset or liability, the entity uses the most advantageous market. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell 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, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities.

17 The Board discussed the concepts of principal and most advantageous markets in its May meeting. During the meeting the Board reached the following preliminary view:

(a) When multiple markets exist for an asset or liability, the fair value measure should be based on the principal market for that asset or liability. If there is no principal market, the most advantageous market should be used. In both instances, the principal or most advantageous market should be determined from the perspective of the reporting entity. [14 for, 0 against per the May 2006 meeting minutes]

18 *Staff Recommendation:* The staff concludes an issue and question should be added to the Invitation to Comment for this topic as this preliminary view

might represent a significant change to practice for some fair value measurements. Do Board members agree with the staff recommendation?

Item 3: Calling level 3 measurements 'fair value'

19 As discussed in the May Board meeting, the FASB's FVM Statement establishes a three level hierarchy for categorising and prioritising inputs for fair value measurements. Level 3 of the hierarchy are unobservable inputs for the asset or liability (that is, they are not observable in the market). Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available. These inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). However, while the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions, the reporting entity should not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions. Nonetheless, the measurement is still called 'fair value' even though it is based on unobservable inputs.

20 The staff observed in the May Board meeting (Agenda Paper 8B) that some might not consider a measurement based on Level 3 inputs to be an appropriate measure of fair value. Rather, they declare 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 (consistent with the discussion in paragraph 267 of the Discussion Paper on Measurement on Initial Recognition). Some Board members have suggested we include a discussion of this view and ask respondents for their views as to whether a Level 3 measurement can represent 'fair value' or whether it should be labelled differently.

21 As noted in paragraph 12 of Agenda Paper 8B from the May 2006 Board meeting, 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 (with the exception of derivatives that are linked to and must be settled by delivery of certain unquoted equity instruments). Therefore, the Staff concluded that unobservable inputs are not inconsistent with a fair value measurement objective in current IFRSs, so long as any the inputs are not inconsistent with market expectations.

22 Additionally, the staff reasons the disclosures that are required by the FASB's FVM Statement achieve a similar objective to labelling a measurement containing significant Level 3 inputs as something other than fair value. The FASB's FVM Statement requires the reporting entity to disclose, among other things, the following information for each interim and annual period separately for each major category of assets and liabilities:

(a) The fair value measurements at the reporting date (or the measurement date if it is an asset or liability measured at fair value on a nonrecurring basis);

(b) The level within the fair value hierarchy in which the fair value measurements in their entirety fall;

(c) For assets and liabilities measured at fair value on a recurring the entity shall disclose a reconciliation of the beginning and ending balances for fair value measurements using significant unobservable inputs (Level 3).

23 *Staff Recommendation:* The staff concludes the disclosure requirements sufficiently highlight the nature of the fair value measurement so that users of financial statements can develop a view of the potential uncertainty of that measurement. Therefore, the staff reasons it is not necessary to include a discussion of whether measurements comprised of significant Level 3 inputs should be labelled something other than fair value. Do Board members agree with the staff's recommendation?

<u>*Item 4: Block premiums and discounts*</u>

24 In reviewing drafts of the FASB's FVM statement, individual Board members questioned whether it was appropriate to limit the prohibition on block premiums and discounts to measurements to Level 1 of the FASB's FVM hierarchy or whether the concept should apply more broadly to all fair value measurements in all levels.

25 The FASB's FVM Statement states that if the reporting entity holds a position (including a block) of a single financial instrument and the instrument is traded in an active market for that instrument, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

26 By comparison, only IAS 39 contains block guidance for fair value measurements in IFRSs. In a discussion of measuring fair value in an active market, IAS 39.AG72 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.' Further, E.2.2 provides the following example for the fair value measurement of a large holding:

> **Entity A holds 15 per cent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is CU100. Daily trading volume is 0.1 per cent of outstanding shares. Because Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price, Entity A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A would be able to obtain a price of CU105, ie a 5 per cent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?**
>
> Under IAS 39.AG71, a published price quotation in an active market is the best estimate of fair value. Therefore, Entity A uses the published

price quotation (CU100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

27 *Staff Recommendation:* The staff concludes the guidance in IAS 39 and the block guidance in the FASB's FVM Statement are convergent. Further, the staff understands that current practice under IFRSs only precludes a blockage adjustments where there is a price in an active market for the security being measured. Expanding the blockage guidance to all levels of the hierarchy would 1) result in a divergent view from US GAAP, and 2) result in an amendment to IAS 39. Therefore, the staff recommends not including a discussion of blockage adjustments in the Invitation to Comment. Do Board members agree with the staff's recommendation?

Item 5: Day-one gains and losses

28 The FASB's FVM Statement provides that, because exit prices are conceptually different to entry prices, fair value at initial recognition might differ from the transaction price. This guidance diverges from IAS 39, which states in paragraph AG 76 that '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.' This difference between the FASB's FVM Statement and IAS 39 was discussed during the June Board meeting. At that meeting the Board directed the staff to include a question in the invitation to comment discussing the divergent guidance in the FASB's FVM statement and IAS 39 on measuring fair value at initial recognition without including a preliminary view on this matter.

29 Some Board members have since expressed concern that the exit price concepts in the FASB's FVM statement, particularly in regards to a fair value measurement at the initial recognition of financial assets and liabilities, might not be adequately explained. As a result, the staff included a question and a

brief discussion of this issue in the draft of the Invitation to Comment shared with Board members.

30 Additionally, some Board members have expressed the view that they believe it is premature to have a discussion of the recognition of day-one gains and losses in the Invitation to Comment of the Discussion Paper. Instead, they suggest focusing on the concepts of entry and exit prices and the basis for each. These Board members have suggested deferring discussions of standard-by-standard application of a fair value measurement standard until deliberations begin on the development of an exposure draft of an IFRS on fair value measurements.

31 *Staff Recommendations:* The staff observes an exit price measurement objective could have significant implications on certain fair value measurements in IFRSs, particularly in IAS 39 on initial recognition. The staff reasons it is important to highlight situations where the guidance in the FASB's FVM Statement differs significantly from current IFRSs. Further, convergence on the day-one gain matter is a high-profile issue to many large financial institutions and is an area where the staff expects many comments. Therefore, the staff recommends keeping the discussion and question on the transaction price presumption in the Invitation to Comment.

32 However, the staff agrees with the Board members that stated they believe it is premature to include a question on how clearly a concept is communicated in the FASB's FVM Statement if the Board has not yet reached a preliminary view on that issue. As such, the staff recommends deleting the discussion from the draft Invitation to Comment [sentence modified in the observer note]. Instead, the staff proposes it would be more appropriate to work with individual preparers and auditors to develop guidance that sufficiently articulates the fair value measurement principles and concepts once they have been established by the Board.

33 Does the Board agree with the staff recommendations?

<u>Item 6: Shading or deleting US GAAP specific information in the FVM Statement</u>

34 Certain aspects of the FASB's FVM Statement are specific to US GAAP and would not be relevant to readers of the Discussion Paper when consider the

affect of applying the provisions of the FVM Statement to IFRS. For example, Appendix D of the FASB's FVM Statement provides a listing of references to US GAAP pronouncements requiring fair value measurements. The staff understands the appendices that are specific to US GAAP will not be reproduced in the Discussion Paper (specifically, Appendix D and Appendix E of the FASB's FVM Statement). However, other than not reproducing these appendices, the staff expects not to make any modification, edits or deletions to the FASB's FVM Statement.

35 Some Board members observed discussions and footnotes in the FASB's FVM Statement that are US GAAP specific and expressed concern that such discussions and footnotes might distract readers of the Discussion Paper. These Board members suggested either deleting such text or shading it with a note that the shaded text is specific to US GAAP and is not relevant to IFRSs.

36 *Staff Recommendations:* The staff acknowledges there are discussions in the FASB's FVM Statement, particularly in the introduction and in the basis of conclusions, that contain numerous references to US GAAP literature and that these references might distract some readers of the Discussion Paper. However, the staff is also aware of the desire of many Board members to issue the Discussion Paper as soon as practicable in order to minimize additional delays to the FVM project. The staff is concerned that identifying which text to shade or eliminate and which text to leave alone might be time consuming. For example, some references to US GAAP are helpful because they can provide the reader with context. To eliminate those references might affect how someone who is knowledgeable of both US GAAP and IFRS comprehends the Discussion Paper. Further, some US GAAP specific items provide references that might be critical to a reader's understanding. For example, a footnote to the FASB's FVM Statement notes the term 'related parties' is used in a manner consistent with its use in FASB Statement No. 57, *Related Party Disclosures*. If this footnote were deleted, readers might falsely assume the definition and guidance in IAS 24 *Related Party Disclosures*. For these reasons the staff recommends not modifying, deleting or altering the text of the FASB's FVM Statement and Appendices A through C in any way. Do Board members agree with the staff's recommendation?

[Appendix omitted from observer note]