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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:	**11 December 2007, London**
Project:	**Fair Value Measurement**
Subject:	**Market Participant View (Agenda Paper 2B)**

INTRODUCTION

1 This agenda paper analyses the market participant view in FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), and compares it to the concept of 'knowledgeable, willing parties in an arm's length transaction' in IFRSs. The analysis considers the current definition of fair value in IFRSs and the preliminary definitions of current entry price and current exit price discussed in November 2007 (Agenda Paper 2).

2 This is the first of the issues to be deliberated in the fair value measurement project. At this meeting the staff will ask the Board to consider whether to adopt the market participant view in SFAS 157, with or without modification, in an exposure draft of an IFRS on fair value measurement.

3 The following table contains the definitions of fair value referred to in this paper.

SFAS 157	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.
IFRSs	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
Preliminary definitions agreed by the Board in November 2007[1]	**Current entry price:** the price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants at the measurement date. To incur a liability, an entity can either originate it or assume it from a third party. **Current exit price:** the price that would be received to sell an asset or paid to transfer or settle a liability in an orderly transaction between market participants at the measurement date. If a liability is transferred to a third party, it is assumed to exist beyond the measurement date; if a liability is settled with the counterparty, it is assumed to cease to exist at the measurement date.[2]

4 Because fair value measurement guidance in IFRSs is dispersed across many standards, the staff has analysed the market participant view by 'generalising' the guidance in the various standards (eg although the guidance in IAS 40 *Investment Property* relates specifically to investment property assets, we considered any references to the fair value of 'investment property' as being applicable to other assets and liabilities measured at fair value). The staff notes that the fair value measurement guidance in IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 are the most comprehensive. As a result, most of the analysis in this paper is based on those IFRSs.

[1] These definitions will be used in a standard-by-standard review to assess whether each fair value measurement currently required or permitted in IFRSs was intended to be a current exit price, a current entry price, or some other basis. These preliminary definitions are subject to change in the light of the results of the standard-by-standard review and the decisions that will be made during the forthcoming deliberations on the fair value measurement project.

[2] The staff will explore differences between settlement and transfer at a future Board meeting.

SFAS 157 GUIDANCE

Description of 'market participants'

5 Paragraph 10 of SFAS 157 describes market participants as:

> …buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:
>
> a. independent of the reporting entity; that is, they are not related parties [footnote reference omitted]
>
> b. knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary
>
> c. able to transact for the asset or liability
>
> d. willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

6 Included in the definition of fair value and the notion of being 'willing to transact' is the condition that the transaction be orderly. In other words, it is not a forced liquidation or distressed sale and it assumes that the seller is not experiencing financial difficulty. SFAS 157 describes an orderly transaction as 'a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities' (SFAS 157.7). This allows a reasonable period of time for information dissemination so that market participants are able to transact at the most advantageous price for the asset or liability at the measurement date.[3] Fair value in SFAS 157, therefore, is not a liquidation or scrap value.

7 Although SFAS 157 does not require the reporting entity to identify specific (and actual) market participants, it 'should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the

[3] The staff will address how the 'reasonable time period for information dissemination' relates to other aspects of the project at the relevant Board meetings.

asset or liability, and (c) market participants with whom the reporting entity would transact in that market' (SFAS 157.11).

Use of market-based assumptions

8 SFAS 157 requires the reporting entity to consider the factors that market participants would take into account in pricing the asset or liability. The basis for conclusions of SFAS 157 describes this:

> Among their many functions, markets are systems that transmit information in the form of prices. Marketplace participants attribute prices to assets and, in doing so, distinguish the risks and rewards of one asset from those of another. Stated differently, the market's pricing mechanism ensures that unlike things do not appear alike and that like things do not appear to be different (a qualitative characteristic of accounting information). An observed market price encompasses the consensus view of all marketplace participants about an asset or liability's utility, future cash flows, the uncertainties surrounding those cash flows, and the amount that marketplace participants demand for bearing those uncertainties. (CON 7.26; SFAS 157.BC32)

9 Because fair value in SFAS 157 is market-based, it does not include entity-specific factors. However, SFAS 157 recognises that there are circumstances in which quoted market prices are not available and that, in such circumstances, an entity will need to use other observable inputs (level 2 of the fair value hierarchy) or unobservable inputs (level 3 of the fair value hierarchy) to apply a valuation technique. Those unobservable inputs:

> …shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability… The reporting entity shall 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. (SFAS 157.30)

10 In other words, an entity may use its own assumptions as a starting point, but it must make adjustments to those assumptions if information is reasonably available that indicates that market participants would make different assumptions in pricing the asset or liability.

11 SFAS 157 states that fair value should be measured using 'valuation techniques that are appropriate in the circumstances and for which sufficient data are available' (SFAS 157.19). It does not express a preference for a particular valuation technique (ie the market approach, income approach or cost approach).

IFRS GUIDANCE

Description of 'knowledgeable, willing parties in an arm's length transaction'

12 The IFRS definition of fair value uses the concept of 'knowledgeable, willing parties' (although some IFRSs use the term 'market participants'). IAS 40 *Investment Property* provides the most comprehensive description of 'knowledgeable, willing parties':

> …The willing buyer and willing seller [both] are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the end of the reporting period. A willing buyer is motivated, but not compelled, to buy. This buyer is neither over-eager nor determined to buy at any price. The assumed buyer would not pay a higher price than a market comprising knowledgeable, willing buyers and sellers would require. (IAS 40.42)
>
> A willing seller is neither an over-eager or forced seller, prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in current market conditions. The willing seller is motivated to sell the investment property at market terms for the best price obtainable… (IAS 40.43)

13 Similarly, IAS 39 states that 'underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale' (IAS 39.AG69). Like in SFAS 157, fair value in IFRSs is not a liquidation or scrap value.[4]

[4] The staff notes that IAS 36 *Impairment of Assets* likewise states that 'fair value less costs to sell does not reflect a forced sale, unless management is compelled to sell immediately' (IAS 36.27). This appears to be inconsistent with SFAS 157 because it is an entity-specific value if management is compelled to sell. However, the staff notes that IAS 36 previously referred to 'net realisable value', not

14 IAS 40 describes an arm's length transaction as a transaction 'between parties that do not have a particular or special relationship that makes prices of transactions uncharacteristic of market conditions. The transaction is presumed to be between unrelated parties, each acting independently' (IAS 40.44).

Use of market-based assumptions

15 Similar to SFAS 157, IFRSs state that a fair value measurement should use assumptions that 'market participants' or 'knowledgeable, willing parties' would use in pricing the asset or liability.[5] For example:

IFRS	Description
IFRS 2 *Share-based Payments*	'The valuation technique shall be consistent with generally accepted valuation methodologies for pricing financial instruments, and shall incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price' (¶17) 'The entity shall consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply' (¶B5) '…factors that knowledgeable, willing market participants would consider in setting the price shall…be taken into account' (¶B7)
Exposure draft of *Proposed Amendments to IFRS 2* (February 2006)	'… the fair value of an equity instrument takes into account all the factors that a knowledgeable, willing market participant would take into account at the grant date…' (¶BC10)
IAS 16 *Property, Plant and Equipment*	'The fair value of land and buildings is usually determined from market-based evidence by appraisal… The fair value of items of plant and equipment is usually their market value determined by appraisal' (¶32)
IAS 19 *Employee Benefits*	'…changes in the fair value of any plan assets are, in effect, the results of changing estimates by market participants…' (¶BC47)

fair value. This highlights one of the differences between net realisable value and fair value: net realisable value can be entity-specific and fair value cannot be.

[5] The staff will address factors (attributes) that market participants would take into consideration in pricing an asset or liability in a future Board meeting. This section contains examples of factors referenced in various IFRSs; however, we are not asking the Board to decide—at this meeting—whether these factors would or would not be considered by market participants when pricing the asset or liability.

IFRS	Description
IAS 39 *Financial Instruments: Recognition and Measurement*	When measuring fair value in an inactive market, the valuation technique should incorporate ‘all factors that market participants would consider in setting a price’ and should be ‘consistent with accepted economic methodologies for pricing financial instruments’ (¶AG76) ‘In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions that market participants would use in setting a price for a financial instrument’ (¶IN18)
IAS 40 *Investment Property*	‘The fair value of investment property shall reflect market conditions at the balance sheet date’ (¶38) ‘…Fair value…reflects, among other things,…reasonable and supportable assumptions that represent what knowledgeable, willing parties would assume…in the light of current conditions’ (¶40)
Discussion paper on *Measurement Bases for Financial Reporting* (November 2005)	‘Fair value estimates may be made using measurement techniques or models that are accepted to reasonably replicate the process that market participants could be expected to use to price assets and liabilities’ (¶258)

16 Like SFAS 157, IFRSs require an entity to use market-based information to estimate fair value when it is available. However, both allow the use of entity-specific information when market-based information is not available. For example:[6]

IFRS	**Description**
IFRS 2 *Share-based Payments*	‘Factors that a knowledgeable, willing market participant would not consider in setting the price of a share option (or other equity instrument) shall not be taken into account when estimating the fair value… For example, for share options granted to employees, factors that affect the value of the option from the individual employee’s perspective *only* are not relevant to estimating the price that would be set by a knowledgeable, willing market participant’ (emphasis added) (¶B10) Restrictions on transfer should be taken into account only to the extent that the restrictions affect the price that a knowledgeable, willing market participant would pay for the asset (¶B3)
IAS 2 *Inventories*	Fair value is not an entity-specific value (¶7)
IAS 39 *Financial Instruments: Recognition and Measurement*	When there is no active market, a valuation technique should maximise ‘the use of market inputs, and [rely] as little as possible on entity-specific inputs’ (¶AG75) ‘IAS 39 requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price’ (¶AG76A) ‘fair value…does not depend on entity-specific factors’ (¶BC97)
IAS 40 *Investment Property*	‘The factual circumstances of the actual investment property owner are not [taken into consideration when determining the best price obtainable] because the willing seller is a hypothetical owner (eg a willing seller would not take into account the particular tax circumstances of the actual investment property owner)’ (¶43) Unlike a value in use measurement in IAS 36 *Impairment of Assets*, a fair value measurement does not reflect an entity’s estimates to the extent that they include factors that would not be available to knowledgeable, willing buyers and sellers (¶49)

[6] The staff notes that some guidance related to current, market-based measurement bases in IFRSs (eg the guidance in the discussion paper on *Preliminary Views on Insurance Contracts*) is consistent with this although the measurement basis is not fair value. The insurance contracts discussion paper emphasises that estimates of cash flows should be consistent with the estimates that market participants would make. However, when estimating servicing costs for example, the discussion paper notes that, in practice, an insurer would use estimates of its own servicing costs unless there is clear evidence that the insurer is significantly more or less efficient than other market participants (the use of entity-specific cash flows is discussed in paragraphs 56-62 of the insurance contracts discussion paper).

17 The staff notes the that the term ‘market participants’ is used in IFRSs, particularly in the most recent publications and amendments, when referring to fair value and other measurement bases. For example, IFRS 2, IFRS 4 *Insurance Contracts,* IFRS 7 *Financial Instruments: Disclosures,* IAS 19, IAS 36, IAS 39, IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*, SIC 31 *Revenue—Barter Transactions Involving Advertising Services*, Discussion Paper of *Preliminary Views on Insurance Contracts* (May 2007), Exposure Draft of a *Proposed IFRS for Small and Medium-sized Entities* (February 2007), Discussion Paper of *Preliminary Views on an improved Conceptual Framework for Financial Reporting* (July 2006), Exposure Draft of *Proposed Amendments to IFRS 2* (February 2006) and Discussion Paper on *Measurement Bases for Financial Reporting* (November 2005).[7]

PRELIMINARY VIEWS IN THE DISCUSSION PAPER

18 The Board’s preliminary view on this issue in the Fair Value Measurements discussion paper was that the market participant view in SFAS 157 is generally consistent with the concept in IFRSs of a knowledgeable, willing party in an arm’s length transaction. However, the Board thought SFAS 157’s market participant view more clearly articulates the market-based fair value measurement objective in IFRSs.

STAFF ANALYSIS

19 This section contains the staff’s analysis of the market participant view in SFAS 157 and compares it to the concept of ‘knowledgeable, willing parties in an arm’s length transaction’ in IFRSs. The analysis considers the components of the definition of market participants in SFAS 157 (independence, knowledgeable, able to transact and willing to transact), identifying market participants, using market participant (market-based) assumptions and issues related to emerging markets.

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[7] Some IFRSs and other publications refer to ‘knowledgeable, willing market participants’. Although ‘market participants’ are not defined in IFRSs, they are described as being knowledgeable about the asset or liability and willing to transact for it. Therefore, it is not necessary to include both ‘knowledgeable, willing’ and ‘market participant’ in the phrase; ‘market participant’ alone is sufficient.

20 The staff has considered the comment letters received on this issue. Respondents to the invitation to comment accompanying the discussion paper generally agreed with the Board's preliminary view. However, some prefer the terminology in IFRSs to that in SFAS 157 because they think the term 'market participants' is misleading when there is no observable market.

21 Although many agree with the market participant view, they have questions about applying it in practice. For example, many respondents wonder how to identify market participants and how to apply 'the assumptions market participants would use'. Practical issues will be addressed in detail with Issue 12 on Application Guidance, but are discussed here at a high level. The comment letter summary is available to Board members upon request.

22 The staff also has included the relevant issues raised by the FASB's Valuation Resource Group on this topic (eg the use of market participant assumptions and identifying market participants).[8]

Independent

23 Although both SFAS 157 and IFRSs refer to a hypothetical transaction between unrelated parties, the words used to describe this are different. The comment letters received indicate that the use of different words to describe a similar concept is confusing.

24 The IFRS definition of fair value refers to an arm's length transaction, which is described in IAS 40 as 'between unrelated parties, each acting independently' (IAS 40.44). This implies that the reporting entity could be one of the 'knowledgeable, willing parties in an arm's length transaction' as long as it is unrelated to the other party to the transaction.[9] The transaction price presumption in IAS 39 (ie the best evidence of fair value is the entity's transaction price, unless there are circumstances that indicate otherwise) is further evidence that the reporting entity could be one of those parties. Other IFRSs do not contradict the transaction price presumption. However, IAS 40

[8] See Agenda Paper 2 from the September 2007 Board meeting for a description of the Valuation Resource Group.

[9] Some respondents to the discussion paper think that IFRSs would allow the use of a reporting entity's transaction if the transaction is at arm's length, even if it is between related parties.

describes the buyer as ‘an assumed buyer’ (IAS 40.42) and states that ‘the willing seller is a hypothetical owner’ (IAS 40.43).

25 The SFAS 157 definition of fair value, on the other hand, refers to a transaction between market participants that are independent from the reporting entity. Some focus on the market participant being ‘independent of the reporting entity’ (the first part of paragraph 10(a) of SFAS 157) and interpret it to mean that the reporting entity is not a market participant (ie they are unrelated to the reporting entity and unrelated to each other). Others focus on ‘that is, they are not related parties’ (the last part of paragraph 10(a) of SFAS 157) and interpret it to mean that the transaction must occur between unrelated parties, one of which could be the reporting entity.[10] Whether the reporting entity is considered to be a market participant can affect future decisions in the project (eg day one gains and losses and the use of market participant assumptions).

26 Some respondents think it is inconsistent for the market participant to be ‘independent of the reporting entity’, while the hypothetical transaction is ‘considered from the perspective of a market participant *that holds the asset or owes the liability*’ (SFAS 157.7, emphasis added). Other respondents think it is not necessary to reconcile these statements; they think the reporting entity simply steps into the market participant’s shoes.

27 The staff thinks that, although the words are different, SFAS 157 and IFRSs contain the same notion of the transaction being between unrelated parties. However, it is unclear whether the reporting entity can be a market participant. The staff recommends using the term ‘market participant’ to emphasise the market-based nature of fair value.

28 **Does the Board agree? Does the Board think the staff should resolve the issue of whether the reporting entity can be a market participant?**

[10] The staff notes that the International Valuation Standards published by the International Valuation Standards Committee state that ‘the present property owner is included among those who constitute “the market”’ when describing the concept of Market Value (IVS 1 *Market Value Basis of Valuation*, paragraph 3.2.4).

Knowledgeable

29 Both SFAS 157 and IFRSs refer to the parties to the transaction being knowledgeable about the asset or liability. IAS 40 describes ‘knowledgeable’ as being:

> …reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the end of the reporting period.

30 Similarly, the basis for conclusions of SFAS 157 states:

> …it would be reasonable to presume that a market participant…would undertake efforts necessary to become sufficiently knowledgeable about the asset or liability based on available information, including information obtained through usual and customary due diligence efforts, and would factor any related risk into the fair value measurement. (SFAS 157.C34)

31 Some respondents are concerned that SFAS 157’s market participant view does not take into account the information asymmetry that exists in ‘real world’ markets and they wonder whether, when there is not an active market, the estimated price should reflect non-public information known to the entity.[11]

32 Both SFAS 157 and IFRSs assume a common level of understanding of the information that is publicly available (generally available in the marketplace or through due diligence efforts); they do not assume that both parties have the same information or that markets are perfectly competitive.[12] However, they would not expect entities to try to guess what others might or might not know about the asset or liability. A rational market participant that holds the asset or

[11] This also relates to the factors (attributes) that market participants would consider when pricing an asset or liability. This will be addressed in a future Board meeting.

[12] This appears to be consistent with other (non-financial reporting) market-based valuation guidance. For example, fair market value is defined for US tax purposes as:

> the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, *both parties having reasonable knowledge of relevant facts*. (IRS Revenue Ruling 59-60 §2.02, emphasis added)

Revenue Ruling 59-60 also states that ‘the hypothetical buyer and seller are assumed to be able, as well as willing, to trade *and to be well informed about the property and concerning the market for such property*’ (§2.02, emphasis added).

The FASB notes in the basis for conclusions of SFAS 157 that ‘fair value’ for financial reporting purposes is generally consistent with ‘fair market value’ for valuation purposes, but it chose not to adopt ‘fair market value’ because it relates mainly to assets (property) and has a large body of interpretive case law that might not be relevant for financial reporting purposes.

owes the liability would try to obtain the most advantageous (exit) price, knowing that the other party might find, through its due diligence or other efforts, information about the asset or liability that could affect the price. Similarly, a rational market participant buying the asset or incurring a liability would try to obtain the most advantageous (entry) price that compensates it for the risk of information asymmetry. Although both parties have different levels of information, the negotiating power of the buyer and seller *in an orderly transaction* results in a transaction price that is acceptable to both parties. Therefore, the staff thinks it is reasonable to assume that the effect on the price due to information asymmetry *in an orderly transaction* is likely to be low in most circumstances.

33 The staff thinks the concept of 'knowledgeable' is consistent between IFRSs and SFAS 157. Neither assumes that markets are perfectly competitive, but they do not expect entities to try to guess what market participants might or might not know about an asset or liability. The staff recommends emphasising that 'knowledgeable' does not assume perfect information on the part of the buyer, but a common level of understanding that can be gained over a reasonable period of time (eg through due diligence efforts).

34 **Does the Board agree?**

Able and willing to transact

35 SFAS 157 and IFRSs have the concept of 'willing to transact'. SFAS 157 describes market participants as willing to transact, being motivated but not forced to do so. It also contains the concept of an 'orderly transaction', which means that the transaction is not a forced liquidation or distressed sale. IFRSs similarly describe 'willing parties' as buyers who are 'motivated, but not compelled, to buy at any price' (IAS 40.42) and 'willing sellers' as sellers that are neither 'over-eager…nor forced…, prepared to sell at any price' (IAS 40.43).

36 SFAS 157 describes being 'able to transact' as the legal and financial ability to transact for the asset or liability in the reference market. Unlike SFAS 157, IFRSs do not explicitly contain the concept of being 'able to transact'.

However, it is implicit that the buyer and seller are able to transact (otherwise it seems the hypothetical transaction would not be contemplated).

37 Some respondents ask how to reconcile the ability and willingness to transact with the notion of a hypothetical transaction. They question the reasonableness of assuming that the entity is ‘able to transact’ in a hypothetical transaction when the entity could not, or rationally would not, enter into such a transaction (ie it might not be willing or able to transact). For example, most liabilities cannot, according to the contractual terms, be transferred (ie the entity is unable to transfer it) or the principal market for an asset might consist of an entity’s competitors and the entity might not be willing to sell the asset to any of them.

38 The staff thinks the market participant notion is not one-sided; both the buyer and the seller should be considered. Although a market participant seller might not legally be able to transfer a liability, a market participant buyer could assume it. An entity could ask, ‘If a market participant buyer was able to assume the seller’s liability, what would it be willing to pay for it?’

39 The staff notes that the concept of being willing (and able) to transact is in the definition of fair value in IFRSs, which contemplates a hypothetical transaction between knowledgeable, willing parties (‘the amount for which an asset *could be* exchanged, or a liability settled...’ (emphasis added)). Although the entity might not intend to enter into a transaction for the asset or liability, the fair value can be estimated as if that the entity is contemplating a transaction by asking, ‘If there was a motivated seller of an asset or liability like mine, at what price would (a) the seller be willing to sell and (b) there be a buyer willing to buy it or take on the obligation?’ The reporting entity simply steps into the market participant’s shoes.

40 The staff thinks both SFAS 157 and IFRSs have the same concepts of being able and willing to transact, but the IFRS description is more detailed with regard to ‘willingness’ and SFAS 157 is more explicit with regard to ‘ability’. The staff recommends providing clarity about the market participants’ willingness to transact, using language similar to that in IFRSs. The staff also recommends providing guidance to help preparers apply the ‘ability to

transact' notion when there are restrictions on the asset or liability (this also will be addressed in a future Board meeting when we discuss attributes of assets and liabilities).

41 **Does the Board agree?**

Identifying market participants

42 Paragraph 11 of SFAS 157 states that it is not necessary for an entity to identify specific market participants in the reference market. IFRSs are silent on the identification of market participants, but states that an entity should use market-based assumptions.

43 Some respondents think the market participant view in SFAS 157 conveys clearly the idea that the transaction between market participants is a hypothetical transaction and that it is not necessary to identify specific market participants in measuring fair value. Others think the reliance on market participants means that the entity must find actual market participants. They wonder how to select market participants from the potential universe of market participants (eg financial buyers, strategic buyers, competitors in the same industry, companies in the same region, companies of similar size, etc.) when considering the assumptions market participants would use and the attributes they would consider when pricing an asset or liability.

44 SFAS 157 does not require the reporting entity to identify specific (and actual) market participants. Rather, it 'should identify characteristics that distinguish market participants generally' (SFAS 157.11). This includes looking to the principal (or most advantageous) market, taking into account factors specific to the asset or liability and considering market participants with whom the reporting entity would transact for the asset or liability. Furthermore, when considering the market participants for a specialised asset, for example, it is assumed that the market participants have access to complementary assets in an asset group (SFAS 157.13(a)). However, it is necessary to distinguish between complementary assets that are available to all market participants and those that would be available only to the reporting entity.

45 Some respondents think the term ‘market participants’ is misleading in situations in which there is no observable market. These respondents prefer the terminology in IFRSs because it does not explicitly use the term ‘market’. However, the staff thinks the existence of a market is implicit in the IFRS description. Whether the market can be observed is not relevant; there is a market for every asset or liability whether or not it is traded on an organised exchange. Although the transaction might be hypothetical, the market is not.

46 The staff thinks the language in SFAS 157 is clear, but requires judgement on the part of the reporting entity to determine which market participants to consider in the circumstances. The staff recommends providing an example in the application guidance to assist preparers with identifying market participants.

47 **Does the Board agree?**

Using market-based assumptions

48 The definition of fair value in SFAS 157 and IFRSs is market-based. SFAS 157 states that, even when there is not an active market for the asset or liability, ‘the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability’ (SFAS 157.30). IAS 39 states that ‘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’. A valuation technique should reflect ‘how the market would be expected to price the instrument and the inputs to the valuation technique [should] reasonably represent market expectations…’ (IAS 39.AG75). In other words, both IFRSs and SFAS 157 rely on factors that market participants would consider in pricing an asset or liability regardless of the entity’s intent to transact. In addition, some respondents think an exit price, by definition, ignores entity-specific factors (ie the price one entity can sell an asset for is the price that another party rationally would buy it for).

49 Some respondents question the representational faithfulness of measurements based on ‘the entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability’ (SFAS 157.30). They

think ‘hypothetical assumptions about hypothetical market participants in hypothetical markets’ do not provide useful information.[13]

50 Some think that there is a fair value for the entity (similar to value in use) and a fair value for market participants and prefer an entity-specific value, particularly when there is no active market. They are concerned that using market participant assumptions that differ from the entity’s own assumptions will result in the recognition of gains and losses that reverse over time until the asset or liability is, in reality, no longer held by the reporting entity (ie it is ‘used up’ or sold). They think such information does not help users to predict the future cash flows generated by *the entity itself* and that it distorts the operating performance of the entity. Furthermore, if an asset is measured initially at fair value, any difference between market participant assumptions and the entity’s own assumptions (including information asymmetry) at initial recognition potentially could result in an impairment upon subsequent remeasurement under the value in use model in IAS 36. However, the staff notes that actual results seldom are the same as originally expected and that this occurs even if entity-specific assumptions are used.[14]

51 Some respondents think that they are not ‘allowed’ to use entity-specific assumptions because SFAS 157 states that ‘the entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability’. SFAS 157 does not require an entity to perform an exhaustive search for the assumptions market participants would use. Rather, SFAS 157 states that ‘the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort’ (SFAS 157.30).

52 Some think it is likely that the entity will use its own data, which generally will be based on market data that is available, but they think this is in fact an entity-specific measurement. They also wonder what is meant by ‘undue cost and effort’ in paragraph 30 of SFAS 157. The staff believes SFAS 157 did not

[13] The staff does not think there is such a thing as a ‘hypothetical market’. See paragraph 45.
[14] The staff notes that entity-specific measures are not always more subjective or less reliable than market-based measures. However, entity-specific measures (eg value in use or net realisable value) are not fair value. They are different measurement bases that are not within the scope of the fair value measurement project.

intend to preclude entities from using their own assumptions as a starting point and only requires that entities make adjustments to their assumptions if they are significantly different from those of market participants. Entities could ask the following questions:

a what would the buyer be prepared to pay and the seller demand to sell?

b what would that party include in the price and what would they not consider (and therefore not pay for)?

53 Even without identifying the market participants, respondents wonder how to choose the market participants on which to base their assumptions since it is unlikely that all would have a common view regarding inputs they would use in pricing an asset or liability. Some also wonder whether they should consider what the 'average' market participant would consider in pricing an asset or liability, or whether they should consider the 'marginal' market participant. The staff believes SFAS 157 does not assume that all market participants have a single view, but the entity must decide which assumptions a market participant would make. In many cases, the assumptions a *marginal* market participant makes will have the greatest influence over a price; a rational entity will transact with the party that will pay the highest amount or charge it the least amount.

54 The staff thinks the language in SFAS 157 is clear, but requires judgement on the part of the reporting entity regarding the assumptions to be used and whether they differ from what other parties in the marketplace would assume in the circumstances. The staff recommends providing further education with regard to using market participant assumptions and considering whether additional guidance is needed at a later date.

55 **Does the Board agree?**

Issues for emerging markets

56 Some respondents question whether the market participant view can be applied to entities in emerging markets. For example, in such situations:

a it might be hard to find a ‘market participant’ as defined in SFAS 157 (ie independent of the reporting entity, knowledgeable, able to transact, willing to transact). They are concerned that this might result in the use of level 3 inputs in many cases, which some think adds an entity-specific element into the fair value measurement;[15] and

b the financial markets in these jurisdictions often are less-developed and potential buyers might not be willing to transact at a similar price for the asset or liability.

57 Although IFRSs and SFAS 157 do not explicitly consider emerging markets, many of their characteristics are the same as or similar to those of inactive markets in developed economies. The staff recommends considering whether the exposure draft of an IFRS on fair value measurement should include guidance that generally addresses situations in which there is no active market.[16]

58 **Does the Board agree?**

SUMMARY

59 Although IFRSs and SFAS 157 use different terminology, the staff thinks the market participant view in SFAS 157 is consistent with the concept of ‘knowledgeable, willing parties in an arm’s length transaction’ in IFRSs. This is consistent with the Board’s preliminary view in the discussion paper. The staff thinks the dispersed guidance in IFRSs might have led some constituents to believe that they are different concepts because (a) each IFRS articulates the concept differently and (b) the words used in each IFRS are different from those in SFAS 157. However, ‘knowledgeable, willing parties in an arm’s length transaction’ is a characteristic of market participants.

[15] At all levels of the hierarchy, the measurement objective is the same: To measure the fair value from the perspective of market participant that holds the asset or owes the liability. Level 3 inputs do not result in ‘entity specific’ values.

[16] The staff will address ‘active’ and ‘inactive’ markets in a future Board meeting, including the distinction between a security that is actively traded and the level of activity of the exchange on which it trades (eg there can be an inactive market for an individual security traded on the New York Stock Exchange).

60 Furthermore, the staff thinks the use of the term ‘market’ better expresses the notion that fair value is a market-based value. This is consistent with the Board’s preliminary view in the discussion paper.

61 The staff thinks the market participant view applies equally to a current entry price and a current exit price. This is because:[17]

a entry price and exit price both are affected in the same way by the presumption that:

i the transaction occurs between unrelated parties,

ii the parties are able to transact and

iii the parties are willing to transact.

b the negotiating power of market participant buyers and sellers will result in a price that compensates the buyer for the risk of information asymmetry.

62 The staff thinks there are several options for the exposure draft of an IFRS on fair value measurement:

a **Option 1**: retain the guidance and language in IFRSs with regard to knowledgeable, willing parties in an arm’s length transaction. This would probably be based on the guidance in IAS 40. Although the analysis in this paper shows that the guidance in IFRSs is generally consistent with that in SFAS 157, we would need to ensure that it meets the convergence objective.

b **Option 2**: use language and principles from both SFAS 157 and IFRSs to arrive at ‘new’ guidance that would apply to both IFRSs and US GAAP (a ‘blank sheet of paper’ approach). This would involve more work than the modifications suggested in this paper (see Option 3) because it would combine the guidance in both. However, it does not mean that we would be starting from the beginning because a lot of the

[17] The staff will address any differences between an entity’s transaction price, current entry price and current exit price at a future Board meeting.

thinking has been done already. Any differences from SFAS 157 would need to be addressed with the FASB to ensure the convergence objective is met.

c **Option 3**: adopt the market participant view in SFAS 157, modified as described in paragraphs 27, 33, 40, 46, 54 and 57 (subject to the Board's decisions on these modifications). Any modifications would need to be addressed with the FASB to ensure the convergence objective is met.

d **Option 4**: adopt the market participant view in SFAS 157 without modification. This would meet the convergence objective but might not result in the 'best' answer.

63 The staff recommends Option 3, adopting the market participant view in SFAS 157 with some modifications. The staff thinks this option provides the greatest chance for improvement and builds upon the thinking in SFAS 157. It also allows the IASB and the FASB to jointly consider the wording and meet the convergence objective.

64 The staff does not recommend Option 1 because simply moves the guidance currently in IFRSs and moves it to a fair value measurement standard. This is does not result in improvements based on the most recent thinking on the issue. The staff also does not recommend Option 2. Although Option 2 might seem to be a 'best practices' approach, the staff does not think it would necessarily be an improvement given the time and effort it would take to complete it and the fact that SFAS 157 contains the most recent thinking on this issue. The staff also does not recommend Option 4 because there are practical implementation issues with some of the language in SFAS 157 and would benefit from modification.

65 **Should the exposure draft of an IFRS on fair value measurement:**

a **retain the guidance in IFRSs with regard to knowledgeable, willing parties in an arm's length transaction (Option 1);**

b **use language and principles from both SFAS 157 and IFRSs to arrive at 'new' guidance that would apply to both IFRSs and US GAAP (a 'blank sheet of paper' approach) (Option 2);**

c **adopt the market participant view in SFAS 157, modified as described in paragraphs 27, 33, 40, 46, 54 and 57 (Option 3); or**

d **adopt the market participant view in SFAS 157 without modification (Option 4)?**