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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **Fair Value Measurement**

Subject: **Reference market (Addendum to Agenda paper 3B)**

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1. Agenda paper 3B recommends that the Board adopt the 'most advantageous market approach' for the reference market. That is, a fair value measurement would be based on the market in which an entity could maximise that amount received from the sale of an asset or minimise that amount paid to [transfer/settle] the liability, considering transaction costs in the respective markets.

2. Upon further reflection, the staff think there are two possible ways to approach this issue, which are not articulated in Agenda paper 3B:

    a. if the Board decides to pursue a most advantageous market approach, it seems an entity should also consider the transportation costs to get the asset or liability to the reference market when determining which market is the most advantageous market.[1] This is because rational, profit-seeking entities would also consider the costs incurred to transport their goods to the respective markets when determining

[1] Unlike transaction costs, transportation costs are included in the fair value measurement of an asset or liability because location is an attribute of the asset or liability and the entity must incur transaction costs to get the asset or liability to a location for sale. Transaction costs, on the other hand, are a by-product of the transaction and do not affect the attributes of the asset or liability.

the market in which to transact. Taking this approach would narrow the potential markets to those in which the entity would transact.

b. although the paper contemplates a principal market approach that is based on the overall level of market activity for the asset or liability, not of the level of activity for the entity, the staff thinks this might be overlooking an important nuance of the fair value measurement approach (see Appendix 1 of Agenda paper 3B). The fair value measurement approach first looks at the unit of account and the attributes (characteristics) of the asset or liability, including the location of the asset or liability. Next (setting aside the highest and best use and valuation premise, which are outside the scope of the paper), the entity looks to the exit market for that asset or liability. Under the principal market approach, the entity would consider the market in which it would transact for the asset or liability with the characteristics and unit of account identified above. If there is more than one market in which the entity would transact, it looks to the market with the greatest volume and level of activity for the asset or liability.

3. Consider the following example:

Farmer Co, located in Florida USA, grows and distributes Florida oranges. Assume that Farmer Co can access the Florida, Michigan and South African orange markets.

Farmer Co usually accesses the Florida market, but on occasion accesses the Michigan market. Further assume that the South African market has the greatest volume and level of activity for oranges worldwide. Farmer Co has never transacted in South Africa. Within the US, the Florida market has the greatest volume and level of activity.

The following table summarises the net proceeds that would be received by Farmer Co if it were to transact in any of these markets.

	Florida	**Michigan**	**South Africa**
Observable market price (gross proceeds)	10	12	15
Transaction costs in the market	1	2	3
Transportation costs to get the oranges to the market	2	5	9
Net proceeds	7	6	4
Fair value (market price less transportation costs)	8 (10 – 2)	7 (12 – 5)	6 (15 – 9)

Most advantageous assessment per SFAS 157	9 (10 – 1)	10 (12 – 2)	12 (15 – 3)
Most advantageous assessment per 2a above (net proceeds)	7	6	4

4. Following the fair value approach in Appendix 1, the unit of account is a basket of oranges in this example. The attributes (characteristics) of the oranges include their quality and their location (Florida). The highest and best use is their current use, and the valuation premise is in-exchange.

5. Under the most advantageous market approach as articulated in paragraph 2a, Florida would be the most advantageous market. It is also the market in which the entity usually transacts. This is different from the most advantageous market proposed in Agenda paper 3B and in SFAS 157, which would have resulted in South Africa being the most advantageous market. That is because the assessment of which market is the most advantageous market under that approach does not take into account transportation costs.

6. Under the principal market approach in paragraph 2b, Farmer Co would refer to the market(s) in which it would transact. It transacts in both the Florida market and the Michigan market. It does not transact in the South African market and, as a result, the South African market would be excluded from the analysis. Of the markets in which Farmer Co transacts, Florida has the greatest volume and level of activity for the trading of oranges. Therefore, Florida is the principal market.

7. Both approaches narrow the universe of potential markets for consideration to those in which the entity would transact, although they go about it in different ways. One does so quantitatively (the most advantageous market approach) and the other does so qualitatively (the principal market approach).

8. The question for the Board is which approach does the Board want to pursue?

9. If the Board wants to pursue a most advantageous market approach, the staff suggests clarifying that transportation costs should be considered in the assessment of which market is most advantageous. Does the Board agree?