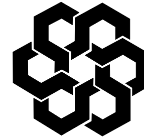

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International Accounting Standards Board

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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: **December 2008, London**

Project: **Fair Value Measurement**

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

Purpose of this paper

1. This paper discusses the market used as a basis for measuring fair value when an entity has access to more than one market. Such a market is referred to as the 'reference market' in this paper.

2. This paper recommends that the Board adopt the 'most advantageous market approach' for the reference market. That is, the market in which an entity could maximise the amount received from the sale of an asset or minimise the amount paid to transfer the liability, considering transaction costs in the respective markets.[1,2]

3. This paper also recommends that the Board clarify how to apply a reference market concept when there is no observable market (ie in Level 3 of the fair value hierarchy).

4. This paper contains:

[1] The staff's recommendation uses the word 'could' rather than the word 'would' in the definition of the most advantageous market to clarify that the reference market is not based on the entity's intentions (what it *would* do), but rather on its ability to access a particular market (what it *could* do).
[2] Agenda Paper 3K asks the Board to decide on the definition for the fair value of liabilities.

a. an overview of the requirements in FASB Statement of Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157),

b. an overview of IFRS requirements, and

c. the staff's analysis and recommendations.

5. The staff's analysis:

a. describes the application of the fair value measurement approach,

b. analyses practical issues raised by constituents, and

c. evaluates four possible approaches for determining the reference market.

Background

6. The Board issued the *Fair Value Measurements* discussion paper in November 2006. Issue 4 of the discussion paper addressed the reference market for measuring the fair value of an asset or liability.

7. In the discussion paper, the Board's preliminary view was that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. This is referred to as the 'principal market approach' in this paper and is the approach taken in SFAS 157.

8. The Board reasoned that:

a. in most circumstances, the principal market for an asset or liability will be the most advantageous market.

b. under the principal market approach, entities need not continuously monitor multiple markets in order to determine which market is most advantageous at the measurement date.

c. the principal market provides a more liquid, and therefore more representative, input for a fair value measurement.

9. The *Fair Value Measurements* discussion paper asked respondents whether they agreed with the Board's preliminary view. The following themes emerged in the responses:

a. the Board should adopt the principal market approach as articulated in SFAS 157.

b. the Board should not adopt the principal market approach, but a most advantageous market approach, because profit-seeking entities will always transact in the most advantageous market (and this is consistent with IAS 39 *Financial Instruments: Recognition and Measurement* and entities already have the systems in place to monitor multiple markets).

c. the Board should adopt an approach based on the market in which an entity usually transacts or expects to transact.

d. the Board does not need to define a reference market for a fair value measurement because these respondents think this notion is encompassed in the highest and best use concept or that each IFRS should stipulate the market on which to base a fair value measurement specific to the asset or liability being measured.

10. Respondents raised several questions about the application of the principal market approach proposed by the Board. Those questions are addressed in the 'staff analysis' section below.

11. A full summary of comment letters received is available to Board members upon request.

SFAS 157 requirements

12. Paragraph 8 of SFAS 157 states that a fair value measurement assumes that the sale of an asset or transfer of a liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. If there is a principal market for an asset or liability, SFAS 157 requires an entity to measure the asset or liability using the price in that market, even if the price in a different market is potentially more advantageous.

13. SFAS 157 defines the principal market and most advantageous market as follows:

> **Principal market**: 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.

Most advantageous market: the market in which the reporting entity would sell the asset or transfer the liability with the price that maximises the amount that would be received for the asset and minimise the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s).

14. Both the principal and most advantageous markets are considered from the perspective of the entity, allowing for differences between and among entities with different activities and access to different markets. This means that the entity must have the ability to access a market in order to base a fair value measurement on it.

15. The exposure draft to SFAS 157 emphasised using the price in the most advantageous market when Level 1 inputs are available. At the time of writing the exposure draft, the FASB believed that the most advantageous market approach was reasonable because 'the goal of most entities is to maximise profits or net assets' and such an approach 'embodies both the buying side and the selling side of rational economic behavior'.

16. Respondents to the exposure draft to SFAS 157 generally agreed with the most advantageous market approach. However, they cited the following concerns about that approach:

    a. it might conflict with the principal market approach for registered funds in Accounting Series Release No. 118 *Accounting for Investment Securities by Registered Investment Companies*, and

    b. it would not be cost effective because it would require continuous evaluations of prices to determine which price is most advantageous at the measurement date.

17. The FASB agreed that its intent was not to require continuous monitoring of all possible markets to find the most advantageous price for an asset or liability. As a result, the FASB decided to pursue the principal market approach because they believed that the principal market for an asset or liability will generally represent the most advantageous market.

18. It is important to note that the principal market approach in SFAS 157 applies to all levels of the fair value hierarchy. The exposure draft to SFAS 157 referred to the reference market only within Level 1 of the hierarchy; however, the FASB expanded

the reference market concept to all levels because it believed the principle underlying the principal market approach should be applied broadly. However, the FASB did not describe how to apply this principle to all levels of the hierarchy. This has led to practical questions about how to apply a reference market concept when there is no observable market.

IFRS requirements

19. IFRSs vary with regard to identifying the reference market. For example:

    a. IAS 39 refers to the 'most advantageous active market to which the entity has immediate access' for a financial instrument;

    b. IAS 40 *Investment Property* refers to the 'best price obtainable by the seller and the most advantageous price reasonably obtainable by the buyer'; and

    c. IAS 41 *Agriculture* refers to the 'most relevant' market for biological assets and agricultural produce when an entity has access to different active markets, whereby the most relevant market is the market 'expected to be used'.

    This diversity might be explained, in part, by a perceived need to tailor the reference market for each asset or liability being measured. More likely, it arises because the guidance was written by different people at different times.

20. It is worth noting that both IAS 39 and IAS 41 refer to an active market. This may suggest that, when there is not an active market, an entity need not identify a particular reference market. The approach in IAS 39 and IAS 41 differs from the principal market approach in SFAS 157, which applies in all levels of the fair value hierarchy.

21. Some IFRSs that require or permit fair value are vague about the reference market. For example, IAS 36 *Impairment of Assets* states that an entity should consider 'the outcome of recent transactions for similar assets in the same industry'. This may suggest that the reference market can be determined by reference to industry practice rather than by reference to a specific market in which an entity could or would transact.

22. Other IFRSs make no mention of the market on which to base a fair value measurement. Such is the case with IFRS 2 *Share-based Payment*.

Staff analysis

23. This section:

    a. Describes the application of the fair value measurement approach and the implications of that approach when determining the reference market.

    b. addresses some of the practical issues raised in the comment letters to the discussion paper, the FASB's Valuation Resource Group (VRG) and through other means.

    c. analyses four possible approaches for determining which market should be the reference market on which to base a fair value measurement.

The Fair Value Measurement Approach

24. The fair value measurement project describes how to measure fair value when required or permitted by IFRSs. It does not address what to measure at fair value. Rather, each IFRS specifies what is to be recognised and the measurement basis for that item.

25. The following describes the fair value measurement approach when an IFRS requires or permits a fair value measurement or disclosure using a current exit price measurement objective:[3]

    Step 1: Each IFRS requiring or permitting fair value specifies the unit of account for the asset or liability (ie the level at which the asset or liability is aggregated or disaggregated for financial reporting purposes).

    Step 2: Once the unit of account is known, the entity assesses the asset or liability's characteristics (attributes) to determine how they should be incorporated into the measurement (ie what is being measured). A market participant would factor these characteristics into the price that it is willing to pay for the asset or that it would demand to assume the liability.

    Steps 3 and 4: Once the asset or liability being measured has been identified and its characteristics are known, the entity determines the valuation premise (ie in-use or in-exchange, also referred to as the unit of valuation) and the highest and best use of the asset (steps 3 and 4 will not be relevant for liabilities, as discussed in

[3] The Board has tentatively decided that fair value is defined as a current exit price. Paragraphs 64-68 discuss the application of a reference market approach to a current entry price measurement objective.

Agenda Paper 3C). This is an iterative process and the sequence of assessing the highest best use and the valuation premise does not matter.

Step 5: The entity looks to the reference market to determine the price at which an orderly transaction would take place between market participants on the measurement date.

See Appendix 1 for a diagram of the fair value measurement approach.

26. The reference market often becomes intuitive once the valuation premise (and the unit of valuation) and highest and best use are determined. For example, if a cash-generating unit is a manufacturing plant comprising two asset classes (machinery and real estate), and the current use of the assets is the highest and best use, there are two possible ways to determine its fair value:

    a. an 'in-exchange' fair value for the machinery and the real estate (eg using the market for used machinery and the market for real estate); or

    b. an 'in-use' fair value whereby a market participant buyer would continue to operate the cash-generating unit in a similar fashion to generate cash flow.

    The fair value would be the higher of these two measurements.

27. In either case, there is likely to be only one market available for each scenario. If measuring the fair value 'in-exchange', there is likely to be one market for the real estate, one market for used machinery and one market for any remaining scrap. If measuring the fair value 'in-use', there is likely to be one market comprised of strategic and financial buyers that would continue to operate the cash generating unit in a similar fashion.

28. However, for more fungible assets and liabilities, an entity might have access to more than one market.[4] In such situations, an entity must determine the reference market for the fair value measurement. The 'Defining the Reference Market' section of the paper addresses this issue.

Practical issues raised

29. This section addresses practical issues raised by constituents, including:

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[4] The reference market notion is most useful when choosing between markets (ie when there is more than one market for an asset or liability). If there is only one market for an asset or liability, the market used to measure fair value is self-evident.

a. Does the principal market approach depend on the level of activity for the entity or for the asset or liability?

b. Is the reference market entity-specific?

c. How does the reference market apply to all levels in the fair value hierarchy? What is the reference market when no market is observable?

d. Does the reference market approach apply to an asset or liability in its current state and condition or does it allow for transformation when the entity intends to sell the asset or liability in a different state or condition?

e. What is the reference market for inventory?

f. How does the reference market apply to liabilities?

g. Does the reference market for a current entry price differ from the market for a current exit price?

30. Many of these questions were raised about the principal market approach taken in SFAS 157. However, they apply equally to the most advantageous market approach. When this is the case, the staff have generalised the question and analysis to apply to both approaches.

Does the principal market approach depend on the level of activity for the entity or for the asset or liability?

31. Many find the definition of the principal market confusing because they are unsure whether 'the greatest volume and level of activity' refers to the entity's trading activity or the overall market activity for the asset or liability. If it is the former, they wonder if that means that the measurement is entity-specific.

32. The staff believe that, in most situations, the market in which an entity would sell an asset or transfer a liability most frequently will be the market with the greatest overall level of activity. In those situations, the principal market using both interpretations. However, in some situations, that might not be the case.

33. The staff thinks 'the greatest volume and level of activity' refers to the overall market activity for an asset or liability. If it did not, the principal market would be the one in which the entity expects to transact. Using the market in which the entity expects to transact removes one of the main features of a fair value measurement: enhancing

comparability across entities by removing the effect of entity-specific intentions.[5] In effect, a fair value measurement provides a market 'benchmark' by which to assess an entity's advantages or disadvantages relative to the market. Linking the principal market to market-based activity rather than entity-based activity would increase consistency in application across entities.

34. The staff's view is consistent with the Board's reasoning in the *Fair Value Measurements* discussion paper that the principal market provides a more liquid, and therefore more representative, input for a fair value measurement. By definition, the market on which an asset or liability is principally traded provides a more liquid input than any other market.

35. If the Board decides to reaffirm its preliminary view in favour of the principal market approach, the staff suggest that the Board clarify that the principal market depends on the overall market activity for the asset or liability, not the level of activity for the entity.

Is the reference market entity-specific?

36. Unlike many of the concepts underlying a fair value measurement (eg highest and best use and the valuation premise), the reference market is considered from the perspective of the entity. This is necessary because different entities have access to different markets.

37. The fair value of an asset or liability could differ depending on the market on which the measurement is based.[6] This is primarily because different markets have different market participants, although they might overlap. The pricing for an asset or liability will reflect the assumptions and preferences of market participants in each market.

38. In the staff's view, measuring fair value by reference to a market in which an entity could not transact would not be representationally faithful. For example, a corporate entity holding an exotic derivative should not assume that it has access to the inter-dealer market when it only has access to the retail market. Rather, it should assume that its position is sold to a market participant that has access to the retail market because that is the market to which the entity has access.

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[5] There is a difference between an entity's ability to access a market and its intention to transact in a market.
[6] Given arbitrage opportunities, the staff would not expect differences in fair value to persist for the same asset; however, an entity might observe different values for an asset in the near term.

39. When evaluating market access on the measurement date, an entity should consider any constraints that would preclude it from accessing a particular market. Such constraints could include (but are not limited to) physical, legal, regulatory or financial constraints.[7]

How does the reference market apply to all levels in the fair value hierarchy? What is the reference market when no market is observable?

40. As noted previously, the reference market approach in SFAS 157 applies to all levels of the fair value hierarchy. The FASB applied the reference market concept to all levels in the hierarchy (rather than limiting its application to Level 1 as proposed in the exposure draft to SFAS 157).

41. Although the staff agree that the principle underlying the reference market should be applied in all levels in the hierarchy, we think that additional guidance is needed on how to apply the reference market concept when there is no observable market.

42. The reference market concept is intuitive for Level 1 and Level 2 of the fair value hierarchy because market participants can be identified readily (eg through an exchange).

43. However, some have questioned the usefulness of the reference market concept when 'there is no observable market' such as in Level 3.

44. In those situations, the staff believe that an entity should focus on identifying the characteristics of market participants with whom the entity could transact. Once the entity has identified the type of market participants with whom it could transact, the entity can determine the reference market for the fair value measurement. The staff understands that this is how some entities think about the reference market in Level 3 in practice.

45. The staff suggest that the exposure draft of an IFRS on fair value measurement clarify this point.

Does the reference market approach apply to an asset or liability in its current state and condition or does it allow for transformation when the entity intends to sell the asset or liability in a different state or condition?

46. Some have questioned whether the reference market concept applies to an asset or liability in its current state and condition or whether it is reasonable to allow for the

[7] Agenda Paper 3H also discusses these types of restrictions on market access.

transformation into another form when the entity intends to sell the asset or liability in a different state or condition.

47. For example, assume that a bank sells a majority of its originated mortgage loans in securitisation transactions. Can the bank use the securitisation market (rather than the whole loan market) as the principal market if there is greater volume and level of activity for mortgage loans in the securitisation market?

48. The staff believe that a fair value measurement applies to an asset or liability in its current form (ie the mortgage loan in the example above). In this case, that means the entity would measure the fair value of the mortgage loan by reference to the mortgage loan market price. Alternatively, the entity could refer to the securitisation market as a means of pricing the mortgage loan by 'backing out' the transformation costs (and the associated margin) necessary to get the mortgage loan securitised.

49. This is consistent with paragraph AG71 of IAS 39, which states that the objective of determining fair value is to arrive at the price at which a transaction would occur at the end of the reporting period *without modifying or repackaging the instrument* (emphasis added). To do otherwise would potentially allow entities to recognise earnings related to the transformation process before the transformation occurs.

What is the reference market for inventory?

50. Some have questioned whether the reference market when measuring the fair value of inventory acquired in a business combination is (a) the market comprising end customers of the product or (b) the market comprising potential buyers who would complete the production and sales processes before selling the product to end customers. They think the wording in SFAS 157 with regard to the description of market participants would point to the former, although practice points to the latter. They also think that, if SFAS 157 points to the former, the fair value of finished goods inventory would be the retail selling price because they view the retail price as a quoted price in an active market for an identical asset (ie a Level 1 input).

51. This raises two questions:

    a. What is the unit of account for inventory?

    b. Is the fair value equal to the retail selling price?

52. IFRS 3 *Business Combinations* (as revised in 2008) does not address the unit of account for inventory acquired in a business combination.

53. IAS 2 *Inventories* does not require inventory to be measured at fair value, although it does provide unit of account guidance for net realisable value. Paragraph 29 of IAS 2 states that 'inventories are usually written down to net realisable value *item by item*. In some circumstances, however, it may be appropriate to *group similar or related items*' (emphasis added). This suggests that the unit of account for inventory could be each item or a group of similar items.

54. Some think that if the unit of account is each individual item of inventory, an entity would refer to a market comprising end customers. However, the sale to the end customer changes what is being measured. That is, once a sale to the customer occurs it is no longer inventory that needs to be prepared and readied for sale to end customers. For that reason, the relevant market to consider is the one comprising market participants who will similarly complete the production and sales processes.

55. Regardless of whether the unit of account is a single item or a group of similar items, the measurement approach is the same—that is, it takes into account that the inventory needs to be prepared and readied for sale to end customers. As such, the retail selling price for the inventory would not represent its fair value, although it might be an input in arriving at fair value.

56. Paragraph B16 of IFRS 3 *Business Combinations* (as issued in 2004) acknowledged that an entity needs to complete the production and sales processes for the inventory to be available for sale to the end customer. It states that the entity (acquirer) shall treat the following measures of inventory as fair value:[8]

   a. for finished goods and merchandise, the acquirer shall use selling prices less the sum of (1) the costs of disposal and (2) a reasonable profit allowance for the selling effort of the acquirer based on profit for similar finished goods and merchandise;

   b. for work in progress, the acquirer shall use selling prices of finished goods less the sum of (1) costs to complete, (2) costs of disposal and (3) a reasonable

[8] FASB Statement of Financial Accounting Standards No. 141 *Business Combinations* (SFAS 157) had similar guidance before it was revised in 2007. The revisions related to the measurement guidance were made because the FASB had issued SFAS 157.

profit allowance for the completing and selling effort based on profit for similar finished goods; and

c. for raw materials, the acquirer shall use current replacement costs.

57. Some wonder if the 'costs of disposal' (selling efforts) are the same as transaction costs as described in SFAS 157. Paragraph 9 of SFAS 157 describes transaction costs as the incremental direct costs to sell the asset. These transaction costs relate to the transaction between market participants to transfer the inventory. On the other hand, the 'costs of disposal' represent the costs that will be incurred by the transferee to sell the inventory to the end customer in due course. A market participant transferee would demand to be compensated for the costs it will incur to complete the sales process and, as such, those costs would be reflected in the fair value measurement.

58. Appendix 2 contains an example of how inventory would be valued using the fair value measurement approach outlined in paragraph 25 and Appendix 1.

How does the reference market apply to liabilities?

59. The reference market concept applies equally to the measurement of assets and liabilities.

60. For liabilities, the reference market is used as a basis for measuring fair value when an entity has access to more than one market. When making that determination, an entity would not consider markets in which it could not transact (ie does not have the ability to access) at the measurement date.[9]

61. SFAS 157 is largely silent on how to apply the reference market concept to liabilities, other than to say that if there is a principal (or most advantageous) market for the liability, it needs to be used.

62. Because liabilities are typically not transferred in observable markets, the staff think it will be difficult to identify the 'market with the greatest volume and level of activity' in many situations. However, the staff believe that a rational entity will always seek to minimise the amount paid to relieve itself of an obligation. As such, the use of the most advantageous market might be more intuitive in those situations.

[9] There is a difference between an entity's ability to access a market and the effect of restrictions on an asset or liability. See Agenda Paper 3E for a discussion of the hypothetical transaction notion.

63. When there is no observable market for a particular liability, the reference market is based on the characteristics of market participants with whom the entity could transfer the liability.

Does the reference market for a current entry price differ from the market for a current exit price?

64. In November 2007, the Board tentatively defined 'current entry price' as:

> The price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants (including the amount imposed on an entity for incurring a liability) at the measurement date.

65. This definition was used for the standard-by-standard review.

66. In July 2008, the Board tentatively decided to define fair value as a current exit price, subject to a scope assessment to indicate whether a current exit price is appropriate in all situations in which fair value is used (eg at initial recognition). The staff are currently undergoing that assessment and plan to bring the results to the January meeting. Fair value is tentatively defined as:

> The price that would be received to sell an asset or paid to [transfer/settle] a liability in an orderly transaction between market participants at the measurement date.

67. Both definitions refer to a transaction between market participants at the measurement date. It follows that a current entry price for an asset or liability might differ from an entity's transaction price for the same asset or liability. This is because (a) when negotiating the transaction price an entity might have used its own assumptions and preferences (not those of market participants) and (b) when effecting the transaction the entity might have accessed a market different from the market that market participants would have accessed.

68. The staff has said that entry and exit prices are the same when the transaction to buy and the transaction to sell occur in the same market. With an exit price definition of fair value, an entity would focus on the market in which a market participant would sell the asset or transfer the liability. Although a market participant's transaction to buy (a current entry price) might occur in a market that is different from the market in which it would sell (a current exit price), the reference market concept applies equally

to current entry prices and current exit prices. As a result, the staff thinks that no additional guidance is necessary.

Defining the Reference Market

69. The remainder of this paper includes the staff's analysis about which market should be used as a basis for measuring fair value when an entity has access to more than one market.

70. The staff believe that there are at least four potential approaches with respect to the determining which reference market concept should be reflected in the exposure draft:

    a. **Approach 1:** Reaffirm the Board's preliminary view in favour of the principal market approach.

    b. **Approach 2:** Pursue a most advantageous market approach.

    c. **Approach 3:** Define the reference market as the market in which the entity expects to transact.

    d. **Approach 4:** Be silent about the reference market.

71. To illustrate the application of each of these approaches, we will use the following example:

    > A financial asset is traded on two exchanges. Entity Y has access to both exchanges at the measurement date. Entity Y would receive CU 25 for the sale of the asset on Exchange A and CU 27 for the sale of the asset on Exchange B. Transaction costs are CU 1 on Exchange A and CU 4 on Exchange B. Exchange A has greater volume and level of activity for the financial asset. Entity Y expects to transact on Exchange B (and historically has done so).

72. It is worth noting that paragraph 24 of SFAS 157 states that a quoted price in an active market for an identical asset or liability, when the reporting entity has the ability to access that market, provides the most reliable evidence of fair value and shall be used to measure fair value whenever available. In other words, when there is a Level 1 price for an asset or liability, an entity must use that price to measure fair value. This would be the case regardless of the approach chosen by the Board.

Approach 1: Reaffirm the Board's preliminary view in favour of the principal market approach

73. Under this approach, the reference market would be defined as the market in which the reporting entity could sell the asset or transfer the liability with the greatest

volume and level of activity for the asset or liability. In the absence of a principal market, an entity would use the most advantageous market as its reference market.

74. This definition of the principal market uses the word 'could' rather than the word 'would' to clarify that the reference market is not based on the entity's intentions (what it *would* do), but rather on its ability to access a particular market (what it *could* do). The use of 'could' also conveys to the reader that entities should not refer to markets that the entity cannot access.

75. In the above example, the principal market for Entity Y's asset would be Exchange A because that is the exchange with the greatest volume and level of activity for the asset. This would also be the case if the item was a financial liability.

76. As discussed previously, the arguments in favour of this approach are as follows:

    a. in most circumstances, the principal market for an asset or liability will be the most advantageous market.

    b. under the principal market approach, entities need not continuously monitor multiple markets in order to determine which market is most advantageous at the measurement date.

    c. the principal market provides a more liquid, and therefore more representative, input for a fair value measurement.

77. Convergence with SFAS 157 is another benefit of reaffirming the principal market approach. If the Board does not choose Approach 1, it would need to consider asking the FASB whether it is open to changing to another approach.

78. Disadvantages of Approach 1 include:

    a. it is incongruous for profit-seeking entities to refer to a market that might not maximise the amount that would be received for an asset and minimise the amount that would be paid to transfer a liability.

    b. referring to the market with the greatest volume and level of activity is not intuitive for Level 3 measurements, leading to confusion about the application of the principal market approach (hence the need to identify the characteristics of market participant with whom the entity could transact).

79. If the Board decides to pursue Approach 1, the staff suggests clarifying that the principal market is the one with the greatest volume and activity for the asset or liability, not for the entity (see paragraphs 31-35 above).

Approach 2: Pursue a most advantageous market approach

80. Under this approach, the reference market would be defined as the market in which the reporting entity could sell the asset or transfer the liability with the price that maximises the amount that would be received for the asset and minimise the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s).

81. As with Approach 1, this definition of the most advantageous market uses the word 'could' rather than the word 'would' to clarify that the reference market is not based on the entity's intentions (what it *would* do), but rather on its ability to access a particular market (what it *could* do). The use of 'could' also conveys to the reader that entities should not refer to markets that the entity cannot access.

82. In the above example, the most advantageous market for Entity Y's asset would be Exchange A because the price on Exchange A, as adjusted for transaction costs, would maximise the net amount received for the asset (CU 24). This was determined as follows:

	Exchange A	**Exchange B**
Price	25	27
Transaction costs	1	4
Net proceeds	24	23

83. Although transaction costs are considered in **determining the most advantageous market**, the price on Exchange A is not adjusted for those costs when **measuring** fair value because transaction costs are not an attribute of the financial asset. Thus, the fair value of the financial asset would be CU 25.

84. The most advantageous market approach was favoured in the FASB's exposure draft to SFAS 157 because it is consistent with the goal of most entities to maximise profits or net assets. For that reason, proponents of Approach 2 argue that it provides the 'most representative' fair value measurement.

85. Although respondents to the exposure draft generally agreed with the most advantageous market approach, some stated that it would not be cost effective. They

indicated that it would require continuous evaluations of prices to determine which price is most advantageous at the measurement date.

86. Interestingly, some respondents to the IASB's *Fair Value Measurements* discussion paper disagreed with the 'undue cost' argument. They indicated that entities already have systems in place to monitor markets to comply with the 'most advantageous market' approach in IAS 39.

87. Although similar Approach 2 is similar to the IAS 39 approach, it differs in some respects. For example, the most advantageous market concept in Approach 2 apples to all levels in the fair value hierarchy, whereas paragraph AG71 of IAS 39 states that the objective of determining fair value for a financial instrument is to arrive at the price at which a transaction would occur in the most advantageous **active market** to which the entity has immediate access (emphasis added).

Approach 3: Define the reference market as the market in which the entity expects to transact

88. Some respondents to the discussion paper suggested that the Board define the reference market as the market in which the entity usually transacts or expects to transact. The staff believe that having a broad description including both notions is likely to render inconsistent results because the 'market in which the entity usually transacts' might not be the same as the 'market in which the entity expects to transact.' For that reason, the staff has narrowed this approach to consider only an entity's expectations. The staff think that defining the reference market as the 'market in which the entity usually transacts' is similar to a principal market approach based on the entity's trading volume for an asset or liability, which the staff did not recommend (see paragraphs 31-35 above).

89. Some favour this approach because they think:

   a. it is consistent with the reference market approach taken in IAS 41, whereby the 'most relevant' market is the market that the entity expects to use, and

   b. it would be peculiar for an entity to refer to a market in which it does not expect to transact.

90. A disadvantage of this approach is that it is intent-based and entity-specific, thereby undermining the comparability of fair value measurements for the same asset or liability across entities. The staff note that this argument is not unique to Approach 3,

as the other approaches also have elements that are entity-specific in terms of market access. The staff think that the real concern is a perceived lack of rigour and consistency in application with an intent-based approach.

91. For that reason, the staff favour Approaches 1 and 2 over Approach 3 because both of those approaches use reference points independent of the entity when selecting between markets that the entity can access.

Approach 4: Be silent on the reference market

92. Some respondents to the discussion paper suggested that the Board need not define the reference market, citing the following reasons:

   a. they think it is encompassed in the highest and best use concept or

   b. each IFRS should stipulate the market on which to base a fair value measurement because they think it is specific to the asset or liability being measured.

93. Highest and best use refers to the use of an asset by market participants that would maximise the value of the asset or asset group. In that sense, Approach 4 is similar to Approach 2 with respect to the measurement of assets—they both seek to maximise the amount received by the entity.

94. Furthermore, the staff has said that the highest and best use concept is not relevant for liabilities. In that sense, Approach 4 differs from Approach 2 in that Approach 2 contemplates minimising the amount paid to transfer a liability. Approach 2 also addresses explicitly the effect of transaction costs in determining the reference market.

95. As noted previously, some IFRSs provide little to no guidance on the reference market for fair value measurements. The staff does not believe this is ideal because it is likely to lead to inconsistency in practice (perhaps even for the same asset categories or classes).

Staff recommendation

96. The staff recommend Approach 2 (ie the Board pursue a most advantageous market approach).

97. The staff believe that the most advantageous market approach is consistent with the goal of entities to maximise profits and therefore renders the most representative fair value measurement. One would expect the most advantageous market to become the market with the greatest volume and level of activity over time.

98. The staff understand concerns about the cost of continuously monitoring multiple markets to determine which market is the most advantageous at the measurement date. However, the staff note that current IFRSs such as IAS 39 and IAS 40 already require a 'most advantageous' approach. Many of the entities who have adopted those standards already have systems in place to identify the most advantageous market.

99. For other entities who have not adopted those standards, the staff believe it is likely (given profit motivation) that those entities transact currently in the most advantageous market, considering transaction costs in the respective markets and the markets for which they have access. Thus, the identification of the most advantageous market would not require an exhaustive search of all possible markets.

100. It is important to note that entities would also need to monitor multiple markets under the principal market approach to ensure that they have identified the market with the greatest volume and level of activity for an asset or liability. Thus, the monitoring concern is not unique to the most advantageous market approach.

101. If the Board is concerned about the cost of monitoring multiple markets, it can simply state that an entity is expected to assess the markets to which it has access, but that it need not undergo an exhaustive search of all possible markets when identifying the most advantageous market.

102. If, contrary to the staff recommendation, the Board decides to reaffirm its preliminary view in favour of Approach 1, the staff recommend that the Board clarify that the principal market depends on the level of activity for the asset or liability, not the entity.

103. Whichever approach is chosen by the Board, the staff recommend that the Board clarify how to apply the reference market concept when there is no observable market. That is, in those situations, an entity should consider the characteristics of market

participants with whom the entity could transact in order to determine the reference market for the asset or liability.[10]

QUESTIONS FOR THE BOARD

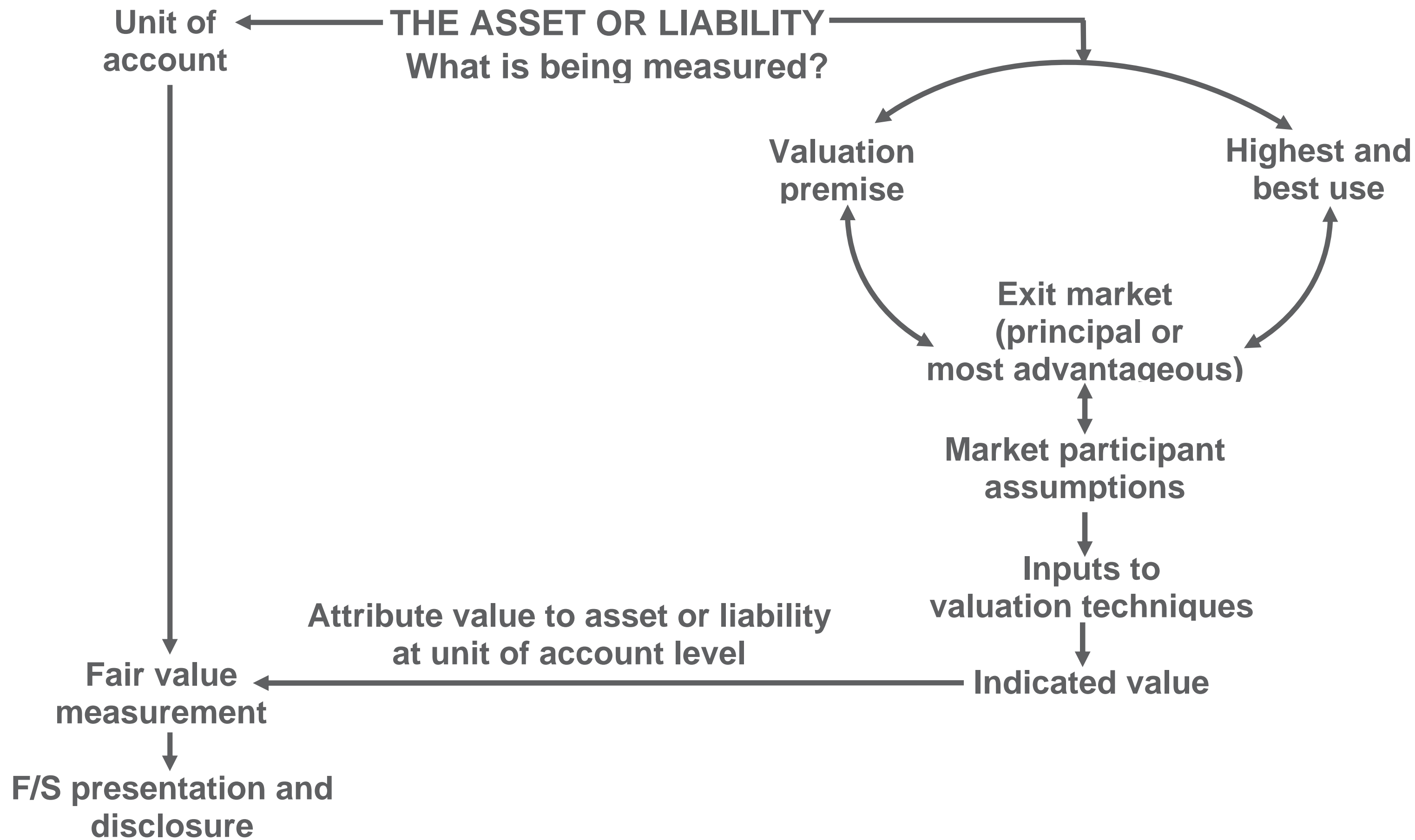
104. **Does the Board agree that the reference market should be defined using a most advantageous market approach? If not, what would the Board like to do, and why?**

105. **If the Board decides to reaffirm it preliminary view in favour of the principal market approach in SFAS 157, does the Board agree that the principal market depends on the level of activity for the asset or liability, not the entity?**

106. **Does the Board agree that additional guidance is needed on how to apply the reference market concept when there is no observable market? If so, does the Board agree with the staff's proposed clarification (ie an entity should consider the characteristics of market participants with whom the entity could transact in order to determine the reference market for the asset or liability)? If not, what would the Board like to do, and why?**

[10] Agenda Paper 3E and 3K address the transferability of assets and liabilities.

APPENDIX 1: Diagram of the fair value measurement approach



APPENDIX 2: Inventory acquired in a business combination

1. Unit of account in the relevant IFRS

Paragraph 29 of IAS 2 *Inventories* states that 'inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to group similar or related items'.

IFRS 3 *Business Combinations* (as revised in 2008) does not address the unit of account for inventory acquired in a business combination.

However, regardless of whether the unit of account is a single item or a group of similar items, the measurement approach is the same.

2. The asset or liability (what is being measured?)

Inventories are assets:

(a) held for sale in the ordinary course of business;
(b) in the process of production for such sale; or
(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. (IAS 2.6)

Inventories are items that are not yet sold at the measurement date. Inventories are not investments and should not be treated as assets held by an entity that is not in the business of selling them (eg machinery used in a production process, investments in financial assets, investments in real estate).

Unsold inventories need to be prepared and readied for sale to customers. They cannot be sold to customers before finishing the production and sales processes.

The sale to the end customer changes what is being measured. That is, once a sale to the customer occurs it is no longer inventory that needs to be prepared and readied for sale to end customers.

There are three general categories of inventory:

(a) raw material,
(b) work in progress, and
(c) finished goods.

In this example, the raw material and work in process inventory being measured is ***inventory that is not in the condition and/or location for sale***. The finished goods inventory has not yet been sold and requires further efforts to make the sale (even if those efforts are minimal).

3. Valuation premise (does the asset generate value by itself (in-exchange) or in combination with other assets (in-use)?)

Inventory needs the production and selling processes to complete the sale to the customer and to generate value. Inventory provides maximum value through its use with other assets as a group. These 'other assets' get the inventory to the condition and/or location necessary for sale to the end customer.

A market participant buyer would deploy **raw materials** and **work in progress** in the inventory production process to get it into the condition for sale to the end customer. Once that process is completed, the entity would need to transport the **finished goods** to a location for the sale (or to hold in preparation for sale) and to complete the necessary selling efforts with the customer.

Inventory does not provide maximum value through its use on a standalone basis because it could not be sold to the customer without undergoing the remaining production and sales processes (even if that process is minimal).

4. Highest and best use (is there another use for the asset?)

The highest and best use for inventory that needs to be prepared and readied for sale to end customers is to complete the production and sales processes. The current use is the highest and best use.

5. Exit transaction for the asset or liability (who are the potential buyers for the asset or liability?)

Potential buyers for the inventory are other entities that can complete the production and sales processes and sell the products to customers.

6. Measurement (selecting valuation techniques, selecting inputs to valuation techniques using market participant assumptions)

The measurement reflects the cost of selling efforts and a profit margin.

For **raw material** and **work in progress**, this is generally calculated as follows:

Fair value = **retail price** – adjustment for the risk of holding/selling – remaining production costs – remaining selling efforts – remaining profit margin

OR

Fair value = **wholesale price** + adjustment for the risk of holding/selling + value of production process to date

For **finished goods**, this is generally calculated as follows:

Fair value = **retail price** – adjustment for the risk of holding/selling – remaining selling efforts – remaining profit margin

OR

Fair value = **wholesale price** + adjustment for the risk of holding/selling + value of production process to date

7. Attribute value to asset or liability at unit of account level

Not applicable for this discussion

8. Financial statement presentation and disclosure

Not applicable for this discussion