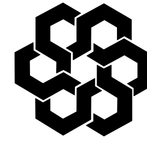

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **Fair Value Measurement**

Subject: **Restrictions on assets and liabilities (Agenda paper 3E)**

Introduction

1. At its June 2008 meeting the Board reaffirmed its preliminary view that a fair value measurement should consider the attributes (or characteristics) of an asset or liability that a market participant would consider when pricing the asset or liability. Implicit in this decision is that a market participant would consider a restriction on an asset or liability only if that restriction would transfer to market participants. This paper asks the Board to confirm that decision.

2. FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) addresses restrictions in the context of assets, but not liabilities. There is limited guidance in IFRSs about restrictions on assets and no guidance about restrictions on liabilities.

3. Although there is little debate about whether a restriction (on an asset) should be taken into account in a fair value measurement, the staff is aware of practical issues with determining whether a restriction on *sale* is specific to the holder of the asset or liability or whether it transfers to market participants. This paper

seeks to clarify such issues. The staff is not aware of such issues when there are restrictions to *use* an asset in a particular way.

4. This paper is organised as follows:

    a. guidance in SFAS 157;

    b. guidance in IFRSs;

    c. IFRIC agenda request about restrictions on financial instruments;

    d. how restrictions relate to the objective of a fair value measurement;

    e. how to determine whether a restriction is an attribute of an asset or an attribute of an entity;

    f. types of restrictions; and

    g. application to liabilities.

5. This paper does <u>not</u> seek to identify all types of restrictions or discuss methods used in practice to place values on these restrictions.

Guidance in SFAS 157

6. Paragraph 6 of SFAS 157 states that a fair value measurement should consider attributes specific to an asset or liability, such as restrictions on the sale or use of an <u>asset</u> at the measurement date.

7. Paragraph A29 of SFAS 157 clarifies when a restriction should or should not be included in a fair value measurement. It states that any restrictions on the sale or use of an asset are characteristics of that asset if those restrictions would transfer to market participants. A restriction on the holder of the asset that would not transfer to market participants is a characteristic of the entity and would not be included in the measurement.

Guidance in IFRSs

8. Like SFAS 157, IFRSs require that restrictions on the sale or use of assets be reflected in fair value when those restrictions transfer to market participants. For example:

a. IAS 40 *Investment Property* states that 'fair value does not reflect [legal rights or legal restrictions that are specific only to the current owner] to the extent that they would not be generally available to knowledgeable, willing buyers and sellers' (IAS 40.49(c)).

b. IFRS 2 *Share-Based Payment* states that the fair value of an equity instrument should reflect restrictions on its transfer: '…if the shares are subject to restrictions on transfer after the vesting date, that factor shall be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share' (IFRS 2.B3).

9. IAS 39 *Financial Instruments: Recognition and Measurement* does not specifically address restrictions in the context of fair value measurement.

IFRIC agenda request about restrictions on financial instruments

10. In September and November 2008 the IFRIC discussed restrictions on securities (see Agenda Papers 6B and 5A from those meetings, respectively). The IFRIC received a request to add an item to its agenda to provide guidance on whether a discount must be applied to the quoted market price when establishing the fair value of a security quoted in an active market when there is a contractual, governmental or other legally enforceable restriction that prevents the sale of the security for a specific period. The request stated that diversity in practice exists when the restriction is specific to the current holder and therefore limited its request for guidance to that situation (there is little or no diversity when a restriction transfers to market participants).

11. The IFRIC decided not to add the item to its agenda because any guidance it could provide would be in the nature of implementation guidance rather than an Interpretation. In the IFRIC's view, any additional guidance that is necessary should be provided by the Board in its project on fair value measurement.

12. The IFRIC agenda request presented two views on restrictions that apply only to the current holder. These views are as follows:

a. **View A**: no adjustment is made to the quoted market value of a security quoted in an active market regardless of the restriction that prevents the sale of the security. Proponents of View A believe that because the restricted shares are identical to the shares that are traded in an active market, IAS 39.AG71 prohibits the application of a discount. Paragraph AG71 states that 'the existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability'. The IFRIC staff favoured this view (the fair value measurement project team also favours this view).

b. **View B**: an adjustment is made to the quoted market value because although there is an active market the entity does not have access to that market as a result of the restriction. Proponents of View B note that IAS 39.AG71 refers to the fair value of a security as the price 'in the most advantageous market to which the entity has immediate access'. As a result, they think an entity always should apply a discount for a restriction when there is an active market for the instrument because, due to the restriction, the entity does not have 'immediate access' to that market. They think a discount should be applied to the quoted market price that represents the cost of using the forward market.

13. The Board tentatively decided in June 2008 that an exposure draft of an IFRS on fair value measurement will use the three-level fair value hierarchy in SFAS 157. SFAS 157 describes Level 1 of the hierarchy as an active market for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. SFAS 157 also states, like IAS 39, that 'a quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available' (SFAS 157.24).

14. Whether 'immediate access' to a market is the same as 'the ability to access' a market at the measurement date mean the same thing is likely to cause debate amongst proponents of View B. The staff's view is that 'the ability to access' in SFAS 157 is a result of the requirement for determining the principal and most advantageous markets for an asset or liability: those markets to which the

reporting entity has access. As a result, the references to 'immediate access' and 'ability to access' seem to mean the same thing—that the entity only has to be able to access the market for the asset or liability, not necessarily that the entity *must* sell the asset or liability on that date. The staff thinks this point should be clarified in the exposure draft.

15. Furthermore, the staff understands that there are practical issues with determining whether a restriction is specific to the holder of the asset or liability or whether it transfers to market participant. The remainder of this Agenda Paper addresses this.

The objective of a fair value measurement

16. The objective of a fair value measurement is to arrive at the price at which a transaction would occur between market participants on the measurement date. This has two implications with regard to restrictions:

    a. A market participant will not pay, or expect to be compensated, for a restriction it does not have. An exit price definition of fair value forces the reporting entity to consider what other market participants would pay for an asset or expect to take on a liability.

    b. Fair value enhances comparability across entities by removing the effect of entity-specific differences. In effect, a fair value measurement provides a market "benchmark" by which to assess an entity's advantages or disadvantages relative to the market.

       Restrictions that are an attribute of an asset (and not to the specific holder) do not result in an advantage or disadvantage for the entity relative to the market because the restriction applies to all participants in that market. However, when a restriction is specific to a particular entity, that restriction might result in a possible disadvantage for the entity relative to the market. Such a disadvantage will appear in profit or loss as those assets or liabilities generate cash flows that differ from their fair values.

How does an entity determine whether a restriction is a characteristic (attribute) of an asset or a characteristic (attribute) of an entity?

17. A fair value measurement takes into account what market participants would consider when pricing an asset or liability. It does not consider the reporting entity's own plans or intentions to the extent they differ from those of market participants. As such, a reporting entity must consider what market participants would pay for an asset on the measurement date.

18. Therefore, when a restriction exists, the reporting entity must consider whether that restriction is an attribute of the asset, or if it is an attribute of the entity.

19. If a restriction is an attribute of an asset, a market participant would be willing to pay less for it than it would pay for an unrestricted asset. This is because the market participant will face the same restrictions when it uses or ultimately sells the asset.

20. On the other hand, if a restriction is not an attribute of an asset, but is specific to the current holder of the asset, that restriction would not transfer to a market participant. As a result, the restriction would have no influence on the price a market participant is willing to pay for the asset.

Types of restrictions

21. Restrictions come in many forms. Restrictions can be legal, regulatory or contractual. Examples of restrictions include:

    a. a restriction on who can buy an asset

    b. a permanent restriction on selling the asset

    c. a temporary restriction on selling the asset

    d. a requirement to use, or not to use, an asset in a particular way

22. This paper does not attempt to identify and address all potential restrictions that could affect a fair value measurement.

A note about hypothetical transactions

23. The following sections assume hypothetical transactions. Some transactions are more hypothetical than others. For example, some find it difficult to

conceptualise a hypothetical sale when there is a permanent restriction from selling an asset. The staff has noticed there are two views of what is 'hypothetical' in a fair value measurement:

a. **View 1**: The entity holds the asset, and **only** the transaction to sell the asset is hypothetical. The market is not hypothetical (it exists whether or not it is observable and whether or not the entity can sell the asset or liability today), and neither are the characteristics of market participants. After the hypothetical transfer, the market participant buyer has the restriction (and therefore would take into account when pricing the asset). In effect, the reporting entity assumes a one-off sale of the asset, for example in a business combination.

b. **View 2**: The entity holds the asset and sells it in a hypothetical transaction. Since the transaction is hypothetical, the market and all circumstances surrounding the transaction are hypothetical. After the hypothetical transaction, the market participant buyer has hypothetical characteristics, as does the hypothetical market. Those who hold View 2 think it is necessary to discard some of the principles of SFAS 157 (or fair value measurement generally) to make these assumptions work.

24. The staff thinks fair value measurement reflects **View 1**. As a result, the following sections are based on this view.

Restrictions on who can buy

25. In some cases, there is a restriction on who can buy an asset. For example, in a private offering of securities, local laws sometimes prescribe that the securities can be sold only to a specific group of qualified buyers (eg based on net worth and financial sophistication). Such a restriction limits the pool of potential market participants.

26. In such a situation, the entity can only sell to a particular set of market participants. Market participants would also be restricted from selling the security to another group of (unqualified) buyers. These market participants would consider the transfer restriction when pricing the asset. As a result, the

restriction is an attribute of the asset and it should be taking into account when pricing the asset.

27. In this example, the entity is able to sell the asset if it chooses to do so. The transaction is hypothetical because the entity has not sold the asset (and might not wish to).

Permanent restrictions to sell

28. A restriction might arise from a transaction or arrangement whereby the entity is restricted because of other elements to the transaction or arrangement. An example of such a situation might be when an entity (Entity A) has a strategic relationship with another entity (Entity B) and as part of that relationship Entity A is required to hold shares in Entity B (and is therefore prohibited from selling them). Another example might be when an entity is prohibited from selling the asset before maturity, for whatever reason.

29. The first example can take two forms. First, assume that Entity B is a publicly-held company with an active market. The strategic relationship developed between Entity A and Entity B such that Entity B required Entity A to hold its shares for as long as the relationship continues. Other investors in Entity B are not required to have strategic relationships and do not have restrictions on their shareholdings. In this case, the restriction is specific to Entity A. Entity A would measure the fair value of the securities at their quoted price. The fair value of the strategic relationship is separate (and it might not be recognised in the statement of financial position).

30. Second, assume that Entity B is a privately-held company. The strategic relationship developed between Entity A and Entity B such that Entity B required Entity A to hold its shares for as long as the relationship continues. Other investors in Entity B are also required to have strategic relationships and have the same restrictions on their shareholdings. In this case, the restriction is specific to the securities. The fair value of the securities would reflect the value of the restriction.

31. In this example, the entity is **not** able to sell the asset, even if it chooses to do so. The transaction is hypothetical for two reasons: (1) the entity has not sold the

asset and (2) it could not even if it wanted to. This does not mean that the entity cannot measure the fair value of the asset or that the fair value is zero.

Temporary restrictions to sell

32. An entity might be restricted from selling an asset for legal, regulatory or contractual reasons. For example, in some jurisdictions, entities that participate in an initial public offering (IPO) (participating entities) are restricted from selling the shares for a specified period. The shares held by non-participating entities are *freely tradable*.

33. Such restrictions are likely to be entity-specific and would not be reflected in the fair value measurement. The fact that the entity participated in the IPO does not affect the attributes of the shares. Going back to the objective of a fair value measurement, if the entity (hypothetically) sells the shares during the restricted period, it will recognise a loss, indicating its disadvantage relative to the market.

34. Such a restriction might not be entity-specific if the restriction is, for example, on all shares, such as if only participating entities hold the shares or if the first and all subsequent holders are subject to the restriction on the shares. In such situations, market participant buyers would be subject to the restriction on these particular shares (ie the restriction transfers to them). As such, the fair value measurement reflects such a restriction.

Restrictions on use

35. An entity might be restricted from changing the use of an asset for legal, regulatory or contractual reasons.

36. Consider the following example:

> Entity M owns a Grade I listed historical office building in London. Entity M is restricted by government regulation from converting the building to another use (such as residential apartments) because modifications are not permitted for Grade I listed buildings.

37. Such a restriction is an attribute of the asset that a market participant buyer would take into consideration when pricing the building. This is because the

Grade I listing regulations would restrict market participants from making any modifications to the building.

38. The same might not be true of other buildings if restrictions are enacted by other means. For example, a local council might decree that a tenant is not allowed to make modifications to a building. In determining whether the restriction is entity-specific, an entity must consider whether future tenants will be restricted similarly. If not, market participants would not consider the restriction when pricing the asset.

39. Restrictions on the use of an asset might limit some of a market participant's potential uses, by rendering a potential alternative use legally impermissible in the highest and best use assessment (see Agenda Paper 3A of the September 2008 IASB meeting).

Application to liabilities

40. SFAS 157 does not address restrictions on liabilities. However, the staff acknowledges that restrictions could apply to the measurement of liabilities. After all, it seems a market participant would expect to be compensated for assuming a liability that it would not be able to transfer.

41. The FASB did not explicitly address restrictions on the transfer of liabilities. This might have been because it seemed to be more applicable to assets given that limitations on the sale of assets might extend to other market participants. In other words, the pricing of the asset would be subject to marketability factors (considering whether the market participant buyer would include a discount for the risk of having to hold the asset for a specified period before being able to transact for the asset).

42. For a liability, the measurement approach in SFAS 157 is a transfer notion. As a result, pricing is not a function of marketability, but of performance. That is, the entity needs to do something to be relieved of the obligation.

43. The staff thinks the basis for conclusions to the exposure draft should address why a restriction on transfer is not reflected in a fair value measurement.

Staff recommendations

44. The staff recommends that the Board:

    a. confirm that, if a restriction on the use or sale of an asset that transfers to market participants, the restriction is an attribute of the asset and should be reflected in a fair value measurement. If the Board agrees to this, the exposure draft will describe how to determine whether a restriction is specific to the holder (entity-specific) or would transfer to market participants.

    b. confirm that, if restrictions on an asset would not transfer to a market participant buyer, they would not affect the fair value of the asset. It is beyond the scope of this project to consider whether those restrictions would qualify for separate recognition in the statement of financial position.

    c. clarify that 'the ability to access' in the definition of a Level 1 input means that the entity only has to be able to access the market for the asset or liability, not necessarily that the entity *must* sell the asset or liability on that date.

    d. address why a restriction on transfer is not reflected in a fair value measurement in the basis for conclusions to the exposure draft.

Questions for the Board

45. Does the Board agree that, if a restriction on the use or sale of an asset that transfers to market participants, the restriction is an attribute of the asset and should be reflected in a fair value measurement?

46. Does the Board agree that, if restrictions on an asset would not transfer to a market participant buyer, they would not affect the fair value of the asset?

47. Does the Board agree to clarify that 'the ability to access' in the definition of a Level 1 input means that the entity only has to be able to access the market for the asset or liability, not necessarily that the entity *must* sell the asset or liability on that date?

48. Does the Board agree that the basis for conclusions to the exposure draft should address why a restriction on the transfer of a liability is not reflected in a fair value measurement?