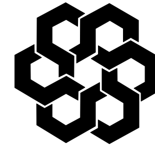


30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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

INFORMATION FOR OBSERVERS

Board Meeting: **19 December 2008, London**

Project: **Fair value measurement**

Subject: **Fair value of liabilities**

Purpose of this paper

1 **This paper does not address whether fair value is the right measurement basis for liabilities. That is a question of '*when to recognise a liability at fair value*' and it outside the scope of the fair value measurement project. This project deals only with '*how to measure the fair value of a liability*'.**

2 This paper recommends that the Board:

a define the fair value of a liability as:

> The price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

b provide guidance about how to measure the fair value of a liability when a transfer price is not observable.

3 If the Board thinks a transfer notion does not work for a particular liability (eg if a liability is better represented using a settlement notion or a fulfilment notion), it will not use fair value as the measurement basis for that liability. The staff will present a

scope assessment in January 2009 indicating where in IFRSs we think the Board or its predecessor did not intend a transfer notion for the fair value of a liability.

4 This paper also asks the Board whether it wants the staff to resolve questions about the measurement basis of deposit liabilities in IAS 39 *Financial Instruments: Recognition and Measurement*.

5 **This paper does not address non-performance risk (credit standing).** Agenda Papers 3H, 3I and 3J address this issue.

Introduction

6 FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) defines the fair value of a liability as:

> The price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

7 The Board's preliminary view as articulated in the *Fair Value Measurements* discussion paper was consistent with the SFAS 157 definition of fair value for liabilities. The Board's preliminary view is in paragraphs 19-21 below.

8 Most of the comments received on the discussion paper were about whether fair value is the right measurement basis for liabilities. This paper will not address this point because it is outside the scope of the project. Other comments included:

a Some think a transfer price is relevant only when:

i there is an active market for the liability on which to base the transfer price;

ii the entity intends to transfer the liability; and

iii the entity has the ability to transfer the liability.

In the absence of the above, they think a settlement notion is more relevant. However, they differ in whether they mean a current settlement or a settlement in due course.

b Some asked whether it is appropriate to use the trading price of a quoted debt instrument (an asset) to measure the fair value (transfer price) of the liability given that the quoted price represents an exit price for the *asset holder*, not a transfer price for the *liability issuer*. Furthermore, some think that, even if the quoted price can be used, it represents a current settlement price, not a transfer price.

c Some think the measurement objective for liabilities in current IFRSs uses a settlement notion, not a transfer notion, particularly for non-financial liabilities, because the current definition of fair value in IFRSs refers to a settlement amount. As result, they view a move to a transfer notion as a change to current practice for non-financial liabilities. As noted above, we will consider this point in January.

9 These comments are analysed in the 'Staff analysis' section below.

10 The FASB's valuation resource group has not yet discussed the measurement of a transfer price for liabilities, presumably because SFAS 157 is not yet effective for non-financial liabilities. The staff is not aware of practice issues with measuring the transfer price of financial liabilities under SFAS 157 (setting aside the issue of non-performance risk).

Guidance in SFAS 157

11 SFAS 157 defines the fair value of a liability as:

> The price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

12 The basis for conclusions to SFAS 157 describes the FASB's rationale for using a transfer notion in the definition of fair value.

> Because the liability is transferred to a market participant, the liability continues; it is not settled with the counterparty. The Board [FASB] acknowledged that in some cases, the reporting entity might not have the intent to transfer the liability to a third party. For example, the reporting entity might have advantages (or disadvantages) relative to the market that would make it more (or less) beneficial for the reporting entity to perform or otherwise settle the liability using its own internal resources. However, the Board

> [FASB] agreed that the fair value of the liability from the perspective of a market participant is the same regardless of how the reporting entity intends to settle the liability. Conceptually, a fair value measurement provides a market benchmark to use as a basis for assessing the reporting entity's advantages (or disadvantages) in performance or settlement relative to the market. Specifically, when a liability is measured at fair value, the relative efficiency of the reporting entity in settling the liability using its own internal resources appears in earnings over the course of its settlement, not before. (SFAS 157.C40)

13 The exposure draft to SFAS 157 defined the fair value of a liability as the price for which it 'could be exchanged'. At least one respondent pointed out that, in contrast to assets, liabilities are not exchanged (but either settled or transferred) and suggested the FASB revise the definition. As a result, the FASB tentatively decided to revise the definition to refer to liabilities as being settled (not exchanged) and to specify that a liability is settled when the reporting entity is no longer obligated to perform, which encompasses within the definition a transfer or legal layoff notion for liabilities.

14 During the redeliberations prior to issuing SFAS 157, the FASB staff's view was that the guidance in FASB Concepts Statement No. 7 *Using Cash Flow Information and Present Value in Accounting Pronouncements* (CON 7) indicates that a settlement notion for liabilities should be considered from the perspective of the reporting entity. A settlement occurs when the reporting entity is no longer obligated to perform, either because it has performed directly by settling the obligation with the counterparty, or because it has performed indirectly by extinguishing its obligation in a transfer to a willing third party of comparable credit standing. The FASB staff noted that CON 7 also indicates that the application of a fair value measurement objective for liabilities should not result in different measurements for the same liability. Rather, different fair value measurements indicate different liabilities. As a result, it is important to define clearly the liability being measured and the appropriate reference market(s) when applying the definition of fair value to liabilities.

15 Therefore, the FASB clarified that, for a liability, fair value should reflect the price that would be paid in a current transaction to transfer the liability to a willing third party of comparable credit standing. They noted that this decision was consistent with the view that an entity will seek to settle its obligations directly or indirectly. Furthermore, the resulting fair value measurement of a liability should be based on

outflows that would occur for market participants, not the entity's expected outflows. This is consistent with the approach used in determining the fair value for assets.

Guidance in IFRSs

16 IFRSs define the fair value of a liability as:

> The amount for which a liability could be settled between knowledgeable, willing parties in an arm's length transaction.

17 IAS 39 contemplates an exchange notion. Paragraph AG75 states that, when an entity uses a valuation model because a quoted price in an active market is not available, '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.' An exchange implies a transfer rather than a settlement.

18 Other IFRSs do not provide fair value measurement guidance for liabilities.

Preliminary view in the discussion paper

19 Although IFRSs define the fair value of a liability using a settlement notion, the IASB's preliminary view is that a transfer notion more accurately describes the fair value measurement objective in IFRSs.

20 This preliminary view was based on existing guidance in IFRSs, which refers to market-based objectives for measuring the fair value of liabilities. Such a market-based objective is consistent with a transfer notion because it excludes entity-specific efficiencies or inefficiencies that might be included in a settlement notion. Rather, a transfer notion reflects market participants' views on settlement of the liability. Market participants that would assume a liability at the measurement date would also assume the obligation to settle with the counterparty to the liability. Therefore, the price that market participants would require in order to assume the liability reflects their views on the expected outflow of resources associated with the ultimate settlement with the counterparty.

21 When developing its preliminary view, the Board noted the following:

a Paragraph B16(l) of IFRS 3 *Business Combinations* (as issued in 2004) refers to a transfer notion for contingent liabilities: 'for contingent liabilities of the acquiree the acquirer shall use the amounts that a third party would charge to assume those contingent liabilities.' [It is worth noting that IFRS 3 (as revised in 2008) requires that an entity measure an acquired contingent liability at the higher of the amount that would be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less cumulative amortisation in accordance with IAS 18 *Revenue*.[1]]

b In IAS 39, paragraphs AG71 and AG72 state that quoted prices in an active market are the best evidence of fair value. Such quoted prices in an active market generally represent a transfer price as opposed to an entity-specific settlement price. Similarly, paragraph AG75 indicates that when an entity uses a valuation model because a quoted price in an active market is not available, '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.' [As noted above, some respondents disagreed with the assertion that a quoted price represents a transfer price rather than a settlement price.]

Staff analysis

22 The staff thinks a transfer notion is the only relevant approach for the fair value of a liability because it is the only approach that:

a is consistent with an exit price notion;

b is market based (ie it is not entity-specific); and

c works for all types of liabilities.

23 It is also the Board's preliminary view in the discussion paper.

[1] The measurement objective in IAS 37 is not fair value. Paragraph 36 of IAS 37 states that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. Paragraph 37 of IAS 37 explains that the best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time.

24 Having said that, there are two other possibilities for describing the measurement objective (not fair value) of a liability:

a **A current settlement notion**. This notion assumes the entity *directly* settles the obligation immediately either by settling with the counterparty or by performing the obligation. It uses entity-specific cash flows, and is not a market-based notion.

b **A current fulfilment notion**. This notion captures the burden of fulfilling the obligation over time. It uses entity-specific cash flows and is not a market-based notion.

25 This paper does not rule out a settlement notion or a fulfilment notion for the measurement of liabilities in some situations. The Board will make that determination when developing future IFRSs.

26 The staff also will keep these notions in mind when performing the scope assessment. **When performing the scope assessment, if it is evident that the Board or its predecessor did not intend a transfer measurement objective for a particular liability recognised currently at fair value (eg it seems that the intention was to reflect a settlement with the counterparty, not a transfer between market participants), the staff will ask the Board to consider whether to exclude that liability from the scope of an IFRS on fair value measurement.**

Defining the fair value of a liability using a transfer notion

27 The staff thinks the definition of fair value for a liability should reflect a transfer notion. The fair value of a liability using a transfer notion would be defined as:

> The price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

28 Advantages of the transfer notion include:

a it seems to be consistent with the IFRS definition of the fair value of a liability. The use of the term ‘settle’ in the current definition does not make sense in the context of an exchange transaction. Settlement directly could only happen in a transaction between the entity and the counterparty (including by performing

the obligation). Settlement indirectly (ie by a transfer), on the other hand, could happen between other knowledgeable, willing parties.

b it is clear that the transfer is deemed to occur at the measurement date.

c it is clear that it is market based; it avoids entity-specific settlement plans because it is measured by reference to how market participants would discharge the obligation.

d it works for situations in which there is no specific, identifiable counterparty (eg asset retirement obligations). In other words, it is applicable for all types of liabilities.

e it reflects the fact that a transferee will not assume an obligation without being compensated for the risk associated with the obligation and/or the profit required to take it on. The inclusion of that compensation differentiates liabilities with uncertain cash flows from liabilities with less uncertain cash flows.

29 Disadvantages of the transfer notion include:

a entities typically do not (and often cannot) transfer liabilities, but settle them in due course by performing the obligation. As a result, it does not reflect the amount the entity will ultimately end up paying (using cash or other resources) to discharge the obligation over time.

b there are very few, if any, observable market prices for liabilities; observable prices are prices for assets and they are only available for financial assets.

30 On balance, the transfer notion seems to be the only approach that reflects a market-based measurement objective, which is consistent with fair value. The measurement issues related to the transfer notion are analysed in the following sections.

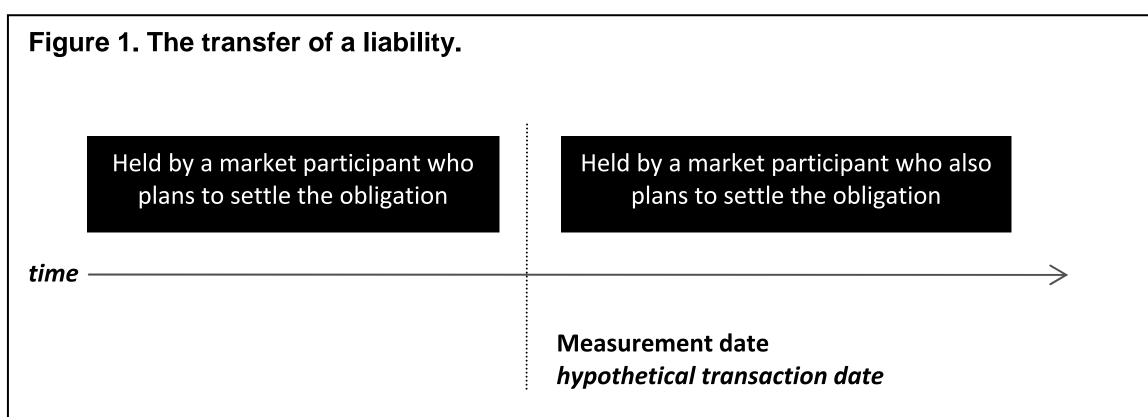
Entities do not (and/or cannot) transfer liabilities

31 The hypothetical transaction (transfer) notion is bothersome to many. In the exposure draft to SFAS 157, the FASB stated that, 'in the absence of an actual transaction for the asset or liability being measured, a hypothetical exchange transaction notion is

essential as a basis for replicating an exchange price for the asset or liability' (paragraph C24). The staff describes how we view the hypothetical transaction notion in Agenda Paper 3E.[2] As a result, we think the hypothetical transaction notion is not a hurdle restricting the ability to measure an asset or liability.

32 Figure 1 shows a hypothetical transfer of a liability between market participants. All else being equal, a change in ownership does not change the fair value of the liability. The measurement date is the date of a hypothetical transaction that provides a point of reference for the valuation. The fair value on either side of the dotted line is the same (except for the passage of time and any changes in market conditions).

Figure 1. The transfer of a liability.



33 Of course, this assumes that the entity and the market participant transferee both plan to settle the obligation in the same way and that they both have the same level of knowledge about the liability.

34 But what if 'all else is not equal'? A liability can be settled directly or indirectly (transferred). The different ways to settle a liability might result in different values from the entity's perspective, given that it has advantages and disadvantages relative to the market. An entity will decide either to settle or transfer an obligation in the way that minimises its outflows, but that is an entity-specific measurement, not a fair value measurement.

35 From the perspective of a market participant that will similarly perform, and failing that, will similarly bear the consequences of not performing, the market outflows

[2] View 1 in paragraph 23 of Agenda Paper 3E relates to *assets*, but applies equally to *liabilities*. View 1 states: 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.

under a settle directly or indirectly (transfer) notion will be the same. In other words, the fair values will be the same from a market participant perspective.

36 The relevance of a fair value measurement is in its ability to provide an objective, unbiased measurement that removes the effect of entity-specific differences (relative advantages and disadvantages to the market), thereby enhancing comparability between and among entities. In effect, a fair value measurement provides a market "benchmark" by which to assess an entity's advantages or disadvantages relative to the market.

37 The staff acknowledges that a transfer notion might not reflect the cash flows that the entity expects to flow from its obligation (given that it is not an entity-specific measurement), but the amount the entity ultimately will pay to settle the obligation does not represent fair value. Assessing whether fair value is the right measurement basis for a particular liability is outside the scope of this project.

Liabilities do not have observable market prices

> **Please note**—This section describes the measurement of a transfer price for liabilities. The FASB staff also is working on this issue as they develop FASB Staff Position FAS 157-c *Measuring Liabilities under FASB Statement No. 157* (FSP FAS 157-c) and we are coordinating with them to ensure we come up with consistent recommendations and, ultimately, consistent guidance. However, for timing reasons we cannot wait for the FASB staff to complete their analysis before finalising this agenda paper. We will bring to your attention any material differences between the analysis in this Agenda Paper and the FASB staff's analysis at the January IASB meeting. If any differences are not material, the staff will address them in drafting.

38 Very few, if any, liabilities have observable market prices on which to base a fair value measurement. If an instrument has an observable price, it is usually as an asset. For example, a debt security issued by Entity L might trade on an exchange. The holders of Entity L's debt security are asset holders and the quoted price is the price of an asset.

39 Some think the fair value of Entity L's liability is equal to the quoted price of the debt security traded as an asset. After all, Entity L could go into the marketplace and buy its own debt, effectively settling the obligation with itself (setting aside (a) whether Entity L has the financial resources to do so and (b) any contractual, legal or regulatory restrictions preventing Entity L from doing so). They think this holds for both financial and non-financial liabilities and that such an approach should be used regardless of whether the asset has an observable market price.

40 Others think the fair value of a liability is not the fair value of the asset to the holder, but that the fair value to the asset holder is one of many factors that the liability issuer should consider in measuring the fair value of a liability. Differences in liquidity might be one reason for differences in value between the asset side and the liability side. In other words, the asset might be freely transferable, but a liability typically is not (without approval).

41 In Agenda Paper 3E the staff addresses the liquidity of liabilities and whether a restriction on transferability should factor into a fair value measurement. In that paper, the staff concludes that it should not, because the pricing of liabilities is not a function of marketability, but of performance. That is, the entity needs to do something to be relieved of the obligation. Using this logic, the view in paragraph 39 seems to hold.

42 However, recent market conditions have led to a decrease in the liquidity of assets. Entity L's quoted debt security is likely to have a higher bid-ask spread today than it did one year ago because the liquidity of the asset has decreased (assuming no changes in Entity L's credit standing). Does that mean that the liability's fair value has decreased by the same amount?

43 On one hand, one could argue that the liability has a lower value because, again, Entity L could go into the marketplace and effectively settle its liability at that price—that is the price market participants holding the assets are expecting to recover on their investment. On the other hand, one could argue that Entity L still owes the principal and interest due on the obligation, regardless of the asset holder's view on recoverability.

44 The staff agrees with the view in paragraph 40—that the fair value to the asset holder is one of many factors that the liability issuer should consider in measuring the fair value of a liability. In other words, it is a starting point and the entity should follow a building block approach.

45 The entity then must ask whether the reference market for the asset is the same as the reference market for the liability. If not, what adjustments need to be made? When there is no observable market for the liability (or even for the asset), the reference market is based on the characteristics of market participants with whom the entity could transfer the liability.

46 The entity also must determine whether it needs to make an adjustment for the risk or profit that the transferee requires to be compensated for assuming the liability. In some cases, such as with a financial liability, this will already be included in the contracted interest rate (the counterparty would aim for a price that recovers, for example, its costs of servicing and the risk of not being paid) and the entity only needs to ensure that this compensation is reflected in subsequent changes in interest rates. With a non-financial liability, this adjustment will be estimated using Level 3 inputs. The entity can think about it in the context of 'what would I require to assume this obligation?'. Certainly the entity, like market participant transferees, will require compensation for stepping into the shoes of the obligor.

47 It is necessary for an entity to include a risk or profit adjustment in the measurement to reflect the price a market participant would demand for assuming a liability. A fair value measurement reflects all factors market participants would consider in pricing the liability, including assumptions about risk. Furthermore, the entity and market participants might have different views about interest rate changes and other economic or operational factors, resulting in different measurements.

48 Some do not like the fact that a transfer price includes adjustments for risk and/or profit because they think the entity will not incur these costs. (Although it could be argued that the entity in fact does incur these costs because it bears the risk of performance and expects to profit on its activities. Whether the entity includes these costs in entity-specific measurements is another issue.) Although an entity will decide either to settle or to transfer an obligation in the way that minimises its outflows, a measurement that reflects that decision is an entity-specific measurement, not a fair value measurement.

49 Furthermore, some think it is difficult to estimate market participant assumptions and would rather use the entity's own assumptions. As noted above, in the absence of observable market data, the entity can think about it in the context of 'what would I require to assume this obligation?'.

50 However, a fair value measurement would not result from an entity's own assumptions to the extent that they differ from those of market participants. A consequence of a fair value measurement is that it shows an entity's advantages and disadvantages relative to the market over time as the entity performs on the obligation.

51 **Any deviation from a market-based fair value measurement crosses into the territory of '<u>when</u> to measure a liability at fair value' and does not address '<u>how</u> to measure the fair value of a liability', so it is outside the scope of this project.**

Fair value of a financial liability with a demand feature

52 This section does not repeat the multitude of discussions and debates the Board and FASB have had in the past about the fair value of deposit liabilities. This section

summarises at a very high level what the issue is and ask the Board for guidance on how to proceed.

53 Paragraph 49 of IAS 39 states:

> The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

54 The basis for conclusions to IAS 39 explains the rationale for this:

> BC93 Some comments received on the Exposure Draft requested clarification of how to determine fair value for financial liabilities with a demand feature (eg demand deposits), when the fair value measurement option is applied or the liability is otherwise measured at fair value. In other words, could the fair value be less than the amount payable on demand, discounted from the first date that an amount could be required to be paid (the 'demand amount'), such as the amount of the deposit discounted for the period that the entity expects the deposit to be outstanding? Some commentators believe that the fair value of financial liabilities with a demand feature is less than the demand amount, for reasons that include the consistency of such measurement with how those financial liabilities are treated for risk management purposes.
>
> BC94 The Board agreed that this issue should be clarified in IAS 39. It confirmed that the fair value of a financial liability with a demand feature is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid. This conclusion is the same as in the original IAS 32 [*Financial Instruments: Disclosure and Presentation*]. The Board noted that in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—ie the demand amount. It also noted that recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the Board believes is inappropriate.

55 Some view this 'deposit floor' as a restriction that overrides the definition of fair value. They think it does not reflect the price at which a transaction would occur between market participants at the measurement date.

56 Others think it is an application of the definition of fair value. They view a demand deposit as giving rise to two separate items:

a the deposit liability itself, whose fair value is typically the face amount, in their view; and

b an intangible asset, representing the benefit the bank expects from customers who do not withdraw their deposits at the earliest possible date.

57 This is the view held by the FASB. Paragraph 12 of FASB Statement of Financial Accounting Standards No. 107 *Disclosures about Fair Value of Financial Instruments* (SFAS 107) states:

> In estimating the fair value of deposit liabilities, a financial entity shall not take into account the value of its long-term relationships with depositors, commonly known as core deposit intangibles, which are separate intangible assets, not financial instruments. For deposit liabilities with no defined maturities, the fair value to be disclosed under this Statement is the amount payable on demand at the reporting date. This Statement does not prohibit an entity from disclosing separately the estimated fair value of any of its nonfinancial intangible and tangible assets and nonfinancial liabilities.

58 This is consistent with paragraph A42 of FASB Statement of Financial Accounting Standards No. 141 *Business Combinations* (revised 2007) (SFAS 141(R)), which states that 'relationships with depositors are frequently exchanged with the related deposits and therefore meet the criteria for recognition as an intangible asset separately from goodwill'.

59 Paragraph 8e of FASB Statement of Financial Accounting Standards No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) scopes out deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions and other similar depository institutions. Phase 2 of the FASB's fair value option project plans to consider deposit liabilities.

60 The staff would like further guidance from the Board on how to proceed with this issue. It will come up again in January when the staff presents an assessment indicating where in IFRSs we think the Board or its predecessor did not intend a transfer notion for the fair value of a liability.

Staff recommendations and questions for the Board

61 Concerns about whether fair value is the right measurement basis are *outside the scope of this project*.

62 Given the uncertainty about what 'settlement' means in the current definition of fair value of a liability in IFRSs, the staff thinks it is important that the definition of fair value for a liability be clear in its objective. Therefore, the staff recommends that the Board reaffirm its preliminary view that the fair value of a liability is 'the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date'. **Does the Board agree? If not, which approach do you want to take?**

63 If the Board thinks a transfer notion does not work for a particular liability, it might decide not to use fair value as the measurement basis for that liability. The staff will present a scope assessment in January indicating where in IFRSs we think the Board (or its predecessor) did not intend a transfer notion when existing IFRSs refer to the fair value of a liability.

64 If the Board agrees with the recommendation in paragraph 62, the staff also recommends that the Board provide guidance about how to measure the fair value of a liability when a transfer price is not observable. At a high level, the type of guidance the staff has in mind is in paragraphs 38-51. **Does the Board agree? If not, why not?**