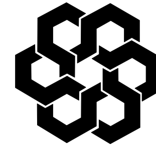

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International Accounting Standards Board

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: **25 July 2008, London**

Project: **Fair value measurement**

Subject: **Standard-by-standard review (Agenda Paper 11A)**

Introduction

1 At its October 2007 meeting, the IASB confirmed its plan to complete a standard-by-standard review of fair value measurements currently required or permitted in IFRSs to assess whether the IASB/IASC intended each fair value measurement basis to be an exit price. For situations in which it did not intend a particular fair value measurement basis to be an exit price, the Board stated that it would assess whether it should develop additional measurement guidance. At that time it seemed that the most likely additional fair value measurement basis candidate would be a current entry price.

2 The findings of the standard-by-standard review are meant to help the Board decide whether to:

a retain the term 'fair value' (or use another term) and define it as a 'current entry price', a 'current exit price' or another measurement basis; or

b replace the term 'fair value' with more specific terms (eg 'current entry price' or 'current exit price') that are appropriate in the individual context.

3 At this meeting, the staff will ask you to decide on a 'definition of fair value' (or, more precisely, a decision on the measurement objective for items with a measurement basis currently referred to as 'fair value'). This paper:

a summarises the process for the standard-by-standard review (Section 1); and

b contains the staff's analysis of the review (Section 2).

4 The staff has not yet considered whether any uses of 'fair value' in IFRSs (eg share-based payments, which are excluded from the scope of FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157)) should be excluded from the scope of a fair value measurement standard. We will present that analysis to the Board at a future meeting.

Preliminary definitions of value

5 For the standard-by-standard review, the Board tentatively decided on the following preliminary definitions of current exit price and current entry price:

a **Current exit price**: 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. This is similar to the SFAS 157 definition of fair value.[1]

b **Current entry price**: the price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants (including the amount imposed on an entity for incurring a liability) at the measurement date. This is the mirror image of the definition of current exit price.[2]

6 In this paper, we sometimes use the words 'current entry price', 'current exit price', 'entry price' and 'exit price'. Even when we do not use the word 'current', we assume that an entry price or an exit price is a current price at the measurement date. In other

[1] The SFAS 157 definition of fair value refers to a liability being transferred, not settled. For the standard-by-standard review we have considered the settlement of a liability because that is in the current definition of fair value in IFRSs. The Board will make a decision about whether a liability should be measured based on a settlement amount or a transfer amount later in this project.
[2] This does not include transaction costs and might not be the entity's transaction price (eg if there are entity-specific factors included in the price).

words, we do not see a difference between a 'current entry price' and an 'entry price' because we assume that the entity measures the entry price at the measurement date (whether at initial recognition or for subsequent measurement).

7 Having said that, there is a historical entry price, eg for something that is recorded at an entry price but is not remeasured. We think that is 'historical cost'. At the time of acquisition, the current entry price is the same as historical cost (excluding transaction costs) for most assets. However, this might not be the case, for example, in a related party transaction or for assets acquired by government grants.

A note on the use of fair value in IFRSs

8 Many are concerned that this project introduces more fair value measurements into IFRSs, or that it will 'pave the way' for the Board to do so in the future because a framework for measuring it will be in place.

9 The staff thinks it is more likely that the opposite will happen. Currently fair value is defined loosely as an exchange amount for assets and a settlement amount for liabilities. This has made it easy for the Board to require or permit its use in a wide range of situations.

10 The staff thinks that if there is a clear, consistent definition of 'fair value' (or whatever it ultimately will be called) there might be *fewer* circumstances in which the Board would require or permit its use. (That is not to say that the standard-by-standard review, or this project generally, will lead to any changes in the measurement bases required or permitted in current IFRSs.)

11 For example, at initial recognition in IAS 16 *Property, Plant and Equipment* an item of PP&E is measured at its cost. Many seem to be concerned that the Board one day might change the measurement basis at initial recognition to be fair value. These concerned parties think it is not appropriate to recognise PP&E at initial recognition at the amount at which it could be sold in a transaction between market participants because they think it would not provide meaningful information. This is of particular concern because the most common difference between entry prices and exit prices occurs when the 'buy' transaction happens in a market different from the 'sell' transaction. Consider the 'classic' new car example: Entity A buys a car from Dealer B

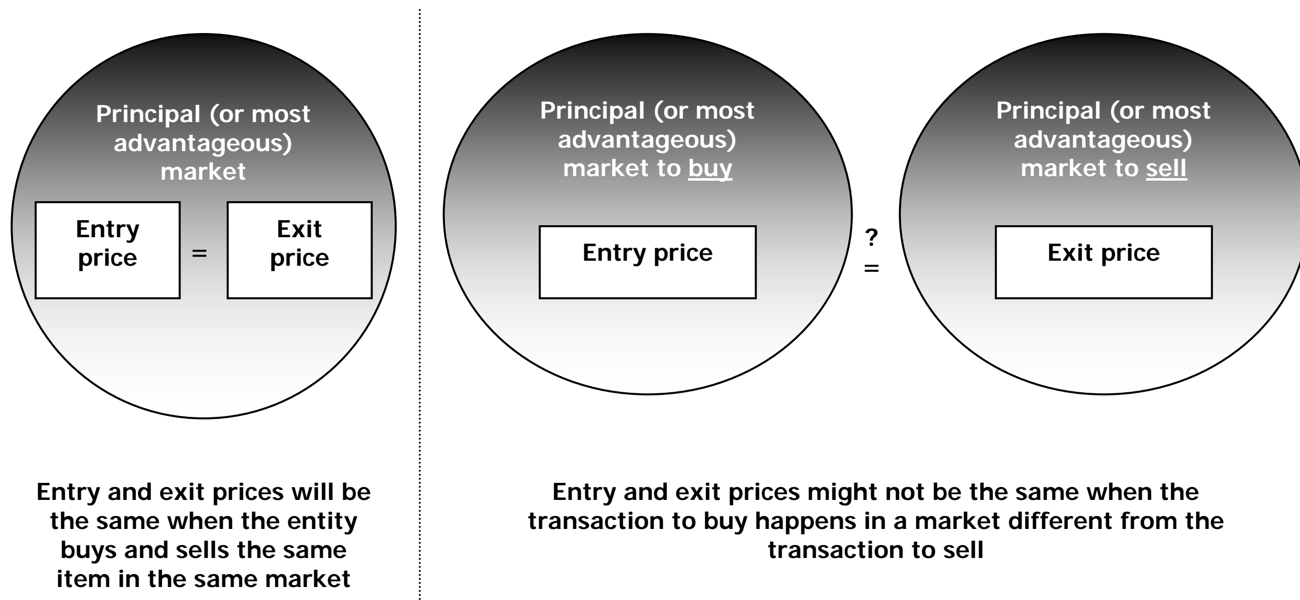
for CU10,000. Entity A can sell it to another party on the same day for CU8,000. Is it meaningful information for A to record a loss of CU2,000 on day one when A has no intention of selling the car but intends to use it in the business?[3]

12 The staff thinks such a situation is precisely why people should not be concerned that the Board could require more fair values just because there is clearer guidance for measuring it—if there is a clear, consistent definition of 'fair value', it will be easier for the Board to ensure that its future uses are appropriate in a given circumstance.

Summary and staff recommendation

13 The analysis in Section 2 of this paper shows that entry and exit prices are equal when they relate to the **same item** on the **same date** in the **same market**. As a result, making a distinction between entry and exit prices, either at initial recognition or for subsequent measurement, is unnecessary and could cause confusion. For practical purposes, an entity should get the same result when referring to an exit price throughout IFRSs as it would if it used entry price for initial recognition and exit price for subsequent measurement if the transactions occur in the **same market**, as shown in the diagram below. We will discuss at a future meeting **which** market should be selected as the reference market.

[3] It can be argued that the *value of the car* does not change. The dealer's price of CU10,000 includes compensation for other factors, eg trust (CU1,000), a warranty (CU500), selling efforts (CU500), in addition to the *value of the car* (CU8,000). When the entity sells it to another party, the price it receives is CU8,000 because that is the *value of the car*. However, IAS 16 does not allow separate recognition of the components of the new car price; the entity recognises a car in the amount of CU10,000. Unless the requirements in IAS 16 change, there will always be this 'counter-intuitive' loss of CU2,000. **This is a topic for discussion at a later date. Such a decision is not within the scope of the fair value measurement project.**



14 After completing the standard-by-standard review, the staff thinks there are two possible approaches for the 'definition of fair value':

a **Approach 1**: define fair value as a current exit price (identical to the definition of fair value in SFAS 157[4]). (Alternatively, the Board can use the term 'current exit price' or another term in place of the term 'fair value'.)

If, in a particular situation, the Board does not think a current exit price is appropriate (eg at initial recognition), it will either (i) not use fair value as a measurement basis in that situation or (ii) allow the entity to use its transaction price as the best evidence of an exit price in the circumstances. This decision will be made in each IFRS that uses fair value as a measurement basis (or for disclosure) at a later stage of this project.

b **Approach 2**: remove the term 'fair value' and replace it with 'current entry price' and 'current exit price'. 'Current entry price' will be used at initial recognition and 'current exit price' will be used for subsequent measurement (it will be difficult to find a principle that allows deviations from this in particular circumstances). Disclosures will be amended to refer to 'current entry price' or 'current exit price' as appropriate.

15 Other approaches that were considered are summarised in the Appendix.

[4] The Board will discuss the settlement and transfer notions for liabilities in a future meeting.

16 Agenda Paper 11B contains examples to illustrate how each approach would look in existing IFRSs. If you have drafting comments about the examples, please let the staff know. [Agenda Paper 11B has been omitted from the observer notes.]

17 Both approaches lead to the same result for subsequent measurement. At initial recognition, they will result in the same measurement if the transaction to buy would occur in the **same market** as the transaction to sell. Note that for current entry price the transaction to buy is a transaction <u>between market participants</u>. This is not necessarily the same as the actual transaction in which the entity acquired the item.

18 The staff favours **Approach 1** for <u>assets</u> for the following reasons (liabilities are discussed below):

a it makes unnecessary any distinction between entry and exit prices at initial recognition;

b although constituents seem to want an entry price at initial recognition, they do not seem to want a theoretical transaction price between market participants in an orderly transaction in the principal (or most advantageous) market for the asset. They think the price the entity actually paid for an asset is more relevant than a theoretical transaction price. Creating a distinction between a current entry price and the entity's transaction price (and reconciling the two) might be confusing in practice;

c Approach 2 might imply that the measurement objective is changing over the course of an asset's life;

d Approach 2's principle of using an entry price at initial recognition and an exit price for subsequent measurement moves away from using the Board/IASC original intentions to avoid inconsistencies amongst the standards in the treatment of initial recognition and subsequent measurement. For example, the staff understands that the measurement objective in IAS 41 *Agriculture* was intended to be an exit price. But if we keep to the Board's intentions how do we explain that biological assets are recognised at an exit price at initial recognition in IAS 41 but that financial assets are recognised at an entry price in IAS 39 *Financial Instruments: Recognition and Measurement* (particularly

for those financial assets that are, like biological assets, remeasured at fair value)?[5]; and

e constituents seem to be becoming more familiar with the idea of an exit price definition of fair value as they begin thinking about how to apply it.

19 The distinction between entry prices and exit prices is less relevant for liabilities than for assets. For liabilities, the current definition of fair value in IFRSs and the definition in SFAS 157 refer to exit prices, although they take different approaches (ie IFRSs refer to a settlement amount and SFAS 157 refers to the transfer between market participants). The definitions are as follows:

> **IFRS**: The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. [Emphasis added.]
>
> **SFAS 157**: the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. [Emphasis added.]

20 This is further complicated by the fact that some interpret 'amount to settle' in IFRSs as the amount to settle with the counterparty today, and others interpret it to mean the amount to settle with the counterparty over time (eg at maturity). No distinction is made between initial recognition and subsequent measurement. This is not specific to liabilities; it also happens with assets. Some interpret fair value to mean the amount the entity ultimately will realise upon settlement or maturity. But a fair value represents the amount an entity would realise in a current exchange transaction in today's market conditions, without regard to its intent to hold the asset for a longer period of time (eg until its price recovers from current market conditions).[6]

21 The staff recommends keeping the exit price notion for liabilities and not introducing an entry price for the following reasons:

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[5] However, some think IAS 39 requires an exit price at initial recognition because of its requirement to use an amount different from the transaction price if that other amount is based solely on observable data. Such observable data reflects inputs based on bid prices for assets and ask prices for liabilities (ie exit prices).

[6] We will discuss liabilities in a future meeting. The staff thinks the amount to settle today and the amount to settle over time will be the same. The amount to settle today is the cash price equivalent of what the entity would pay in the future.

a an entry price is not consistent with the current definition of fair value for a liability in IFRSs; and

b an entry price does not seem to work well for situations in which the entity does not receive consideration in exchange for incurring a liability. For example, an entity might incur a liability when an obligation is imposed on it by a government authority. In one sense, the **actual** entry price was zero. On the other hand, an entity would not willingly take on such an obligation for no consideration. Although an entry price could be defined as the minimum price an entity would require to induce it to take on the liability, that price would be purely hypothetical.

22 We will ask the Board to discuss the notions of settlement and transfer at a future meeting.[7]

Questions for the Board

Initial recognition

Q1 In each IFRS that uses fair value to measure an asset or liability at initial recognition, does the Board agree to define that fair value as a current exit price?

Q2 If the Board answered 'yes' to Q1, should 'fair value' be 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.

(At a future meeting, the staff will ask the Board whether there should be a presumption in each IFRS that uses fair value at initial recognition that the transaction price is the best evidence of a current exit price.)

Q3 If the Board answered 'no' to Q1, does the Board agree, for each IFRS that uses fair value to measure an asset at initial recognition, to define that as a current entry price?

[7] We will consider separately whether the proposed definition of current exit price of a liability is also appropriate for an entity's own equity instruments. However, Approach 1 makes this issue irrelevant.

Q4 If the Board answered 'yes' to Q3, should a current entry price be defined for <u>assets</u> as:

> the price that would be paid to acquire an asset in an orderly transaction between market participants at the measurement date.

(At a future meeting, the staff will ask the Board whether there should be a presumption in each IFRS that uses fair value at initial recognition that the transaction price is the best evidence of a <u>current entry price</u>.)

Q5 If the Board answered 'yes' to Q3, does the Board agree to define the fair value of <u>liabilities</u> at <u>initial recognition</u> as a <u>current exit price</u> (ie not to introduce an entry price notion)? (The Board will discuss the settlement and transfer notions at a future meeting. The staff will think separately about equity instruments.)

Subsequent measurement

Q6 In each IFRS that uses fair value for subsequent measurement of an <u>asset or liability</u>, does the Board agree to define that fair value as a <u>current exit price</u>?

Q7 If the Board answered 'yes' to Q6, should 'fair value' be 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.

Other

Q8 If the Board agrees with the proposals in Q1, Q2, Q6 and Q7, do you prefer to replace the term 'fair value' with another term? If so:

a **do you suggest replacing it with 'current exit price'? or**

b **do you have another suggestion?**

Section 1: The review process

23 The standard-by-standard review addressed whether particular uses of fair value represent an entry price or an exit price, both conceptually and numerically. We performed the review in two phases.

a **Phase 1: Internal review.** The fair value measurement project team performed an initial assessment of the IASC/IASB's intentions for each use of 'fair value' within a particular standard, considering initial recognition and subsequent measurement separately. We used the 2007 Bound Volume to do this. The senior project managers and the relevant project teams then reviewed this initial assessment.

b **Phase 2: External review.**[8] We provided external reviewers with a table of fair value measurements in IFRSs and the relevant guidance for each and asked them to comment on how they interpret a particular fair value measurement in practice. We asked them the following:

i whether, when applying or using fair value measurement guidance in IFRSs, they consider the measurement basis to be an entry price or an exit price. We asked them to focus on how fair value is interpreted in *current* IFRSs, not what the measurement basis *should* be.

ii whether, and if so how, they distinguish between the entry prices and exit prices.

iii whether there are other measurement bases that are included in the notion of 'fair value' (ie besides current entry price and current exit price).

iv whether the fair value of a liability can ever represent an entry price (given that the current definition of fair value in IFRSs refers to a settlement amount, which is an exit price) and whether equity and liabilities should be measured on the same basis.

[8] We received responses from nearly 50 respondents, including preparers, auditors and users, from around the world.

- to identify potential differences between entry price and exit prices that are not related to differences in unit of account, different markets, information asymmetry or transaction costs.

Section 2: The standard-by-standard review

24 This section contains the staff's analysis of the standard-by-standard review. It also includes the input received from the external reviewers.

25 The internal review brought to light no discernable pattern of the Board/IASC's intentions for the use of 'fair value' within each IFRS. Similarly, the findings of the external review group highlighted that there are inconsistencies in application or interpretation in practice.

26 Even so, the following points were notable when performing the review and analysing the results.

The entry and exit price notions apply only where 'fair value' is used in current IFRSs

27 The objective of the fair value measurement project is to provide guidance for measuring fair value when it is required or permitted in current IFRSs. It is **not** about introducing new fair value measurements and does **not** call into question whether an existing use of fair value should be changed to another measurement basis. **The standard-by-standard review, therefore, will not lead to a change in the measurement basis in any standard.**

28 Fair value contemplates an exchange transaction. The current definition of fair value in IFRSs does not distinguish between the buyer's perspective and the seller's perspective, whereas FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) defines fair value from the seller's perspective. Because of this apparent difference in focus, the standard-by-standard review considered which side of the exchange transaction the Board/IASC intended in a particular circumstance. It also looked at whether this distinction matters.

An exit price is not a liquidation value

29 Some think that the definition of fair value in SFAS 157 leads to liquidation values because it refers to the price to sell an asset or transfer a liability at the measurement date. But an exit price also allows for situations in which an entity generates cash by using the asset (in-use). An exit price presumes that the holder uses the asset in the same way that market participants would use the asset, as long as the asset is being used according to its highest and best use. In most situations, this will be the case. (The

staff will present a detailed analysis of the highest and best use concept, including the valuation premise, at a future Board meeting.)

30 The in-use concept of an exit price is best explained with an example.

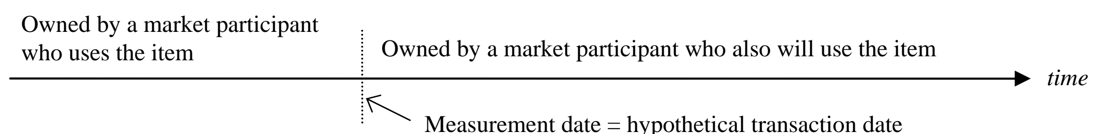
31 Entity A bought specialised machinery for 100, including installation costs. IAS 16 requires that the machinery be recognised at initial recognition at cost, which is 100. Entity A uses the machinery in its manufacturing business.

32 Assume that Entity A **chooses** to use the revaluation model in IAS 16 and revalues the machinery at fair value at each reporting date (subject to the requirements in that standard). If Entity A did not choose to use the revaluation model, it would have used the cost model. Entities choose whether they use the revaluation model, depending on their circumstances—not all entities will choose to apply it.

33 When applying the revaluation model, the fair value of the machinery reflects:

- a that it is being *used in the business* based on the presumption that a market participant buyer of the machinery also would *use* it in its manufacturing business (if it is being used by the entity at its highest and best use, which most often will be the case).
- b the machinery's characteristics (including its age and the fact that it is a used (not new) asset).

34 The diagram below shows the life of an asset or liability. Assuming no change in economic circumstances, the fair value of the asset or liability is the same to the left and to the right of the dotted line (excluding any effects due to the passage of time). Only the ownership 'changes', and who the owner is has no bearing on the fair value of an asset or liability (by definition it *must* be this way because fair value is market-based).



Entry and exit prices will be equal when they reflect the same item on the same date in the same market and when the buyer and seller have the same level of information

35 We asked the external reviewers to tell us whether they thought there is a difference between entry and exit prices and, if so, what that difference might be. We provided the following list of potential differences:

a **differences in unit of account**: the unit of account for buying an asset or assuming a liability might be different from the unit of account for selling the asset or transferring the liability. For example, an entity might buy assets individually and sell them in portfolios or in combination with other assets. The fair value of the individual asset might differ from the fair value of that asset within the portfolio or combination of assets.

b **different markets**: an entity might buy an asset or assume a liability in one market (eg a wholesale market) but sell the asset or transfer the liability in another market (eg a retail market). The price in one market might differ from the price in the other market.

c **information asymmetry**: the entity that holds an asset or liability might have information about the asset or liability that is different from the information available to the entity that wants to buy the asset or assume the liability.

d **transaction costs**: the entity might incur transaction costs when buying or selling an asset or liability. Currently, in both IFRSs and SFAS 157 a fair value measurement does not include transaction costs. Rather, they are, in some cases, separately added to or deducted from fair value in arriving at an amount to recognise, depending on the requirements of a particular standard.

36 We did not consider two other potential differences described in paragraph 17 of SFAS 157—transactions not at arm's length and transactions under duress—because we do not think of the prices for such transactions as 'fair values'. The definition of fair value in SFAS 157 (and in IFRSs, although they use different words) presumes an orderly transaction between unrelated market participants.

37 The only identifiable difference between entry and exit prices seems to exist when the transaction to buy occurs in a **different market** from the transaction to sell.

38 Changing the **unit of account** (or unit of valuation) changes the 'thing' being measured. Once you are measuring a different 'thing', of course there can be a difference in the price of those 'things'.

39 **Information asymmetry** does not belong in an assessment of fair value. We assume that the parties to the transaction are equally knowledgeable about the asset or liability and the transaction (although they do not necessarily know *everything* there is to know).

40 **Transaction costs** are not part of the assessment of fair value. Each IFRS addresses the treatment of transaction costs.

41 Some wonder if **highest and best use** and **the valuation premise** might lead to a difference between entry prices and exit prices. For example, if the entity buys an asset intending to use it in a way that is beneficial to the entity but that is not its highest and best use or if one entity would use the asset in combination with other assets and another would use it standalone.

42 The staff thinks this is an unlikely situation at initial recognition.[9] If there is a market price, or if a transaction occurs between market participants (one of which might be the reporting entity), the price will reflect the highest and best use of the asset. Clearly the seller will obtain the best price available for the asset and the market participant willing to pay the highest price (reflecting the highest and best use of the asset) will be the winning bidder. In such a situation, the entry price, reflecting the highest and best use of the asset, and the exit price, also reflecting the highest and best use of the asset (why would the reporting entity sell it for less?), are the same.

43 Because the market (or transaction) price reflects the highest and best use of the asset, it also reflects the valuation premise. That is, it reflects whether the asset's value is maximised in combination with a group of assets (in-use) or as a standalone asset (in-exchange). Therefore, as with highest and best use, the valuation premise should not result in a difference between entry and exit prices.

[9] Whether there is a difference for subsequent measurement is not relevant under either Approach 1 or Approach 2 because they both use a current exit price for subsequent measurement.

Recognition of profit or loss at inception

44 Many discussions about entry and exit prices centre around the recognition of profit or loss at initial recognition (day one gains or losses).

45 Because fair value assumes an arm's length exchange transaction between knowledgeable, willing parties, there might be a difference between an entity's transaction price and fair value (whether a current entry price or a current exit price), for example because of entity-specific factors. This is because fair value is always market-based.

46 The Board might decide in a particular IFRS to include a rebuttable presumption that the entity's transaction price represents fair value (exit price or entry price) unless there is evidence to the contrary (eg if the transaction was not arm's length, if the transaction was under duress or if the entity has special circumstances available to it that were factored into the price). SFAS 157 states that the transaction price and fair value (exit price) will often be the same, but the burden is on the entity to 'prove' that the transaction price represents fair value. IAS 39, on the other hand, relies on the transaction price as the best evidence of fair value, unless the entity can 'prove' that it transacted at other than a market price.

47 However, the staff is not looking at day one gains or losses at this stage. The issue of whether to recognise day one gains or losses is mainly about reliability, that is whether there are observable market prices and/or inputs. We will address that issue separately and raise it at a future Board meeting.

Do we need to have an entry price and an exit price?

What a fair value communicates to users

48 The objective of a fair value measurement, as described in SFAS 157, seems to be to provide the user with information about the cash flow generating ability of the item being measured at fair value. Many think this is appropriate for subsequent measurement but some question whether it is appropriate for initial recognition because initial recognition is the first time the entity recognises the asset or liability (ie it is the 'entry').

49 At initial recognition, the transaction could be reflected in one of three ways:

a comparing the transaction price with a current entry price would determine whether the entity transacted at arm's length. For example, it might be useful to see that an entity bought a financial asset for 90 from another party when the market price was 100 (almost like a reasonableness check).This is similar to the 'current entry price' notion.

b recognising the transaction at a current entry price would show whether the entity has realised or unrealised day one gains or losses, for example by transacting in different markets.

c recognising the transaction at the transaction price (historical cost) reflects what the entity actually paid.

50 Those with the latter view (to reflect what the entity actually paid) think fair value should not be used at initial recognition and only is relevant for subsequent measurement, if at all. They prefer to use the entity's transaction price at initial recognition. Some think that, if the item will not be remeasured at fair value, it should be recognised initially at cost (and held at amortised cost or another cost basis after initial recognition). Such issues are outside the scope of this project because this project will not change the measurement basis for any asset or liability in existing IFRSs.

Initial recognition occurs only once the entity owns an asset or has a liability

51 The following IFRSs have fair value at initial recognition and/or frequently are the subject of discussions about fair value:

IFRS	**Initial recognition**	**Subsequent measurement**
IFRS 3 *Business Combinations*	FV	Depends on IFRS
IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*	FV	FV
IAS 16 *Property, Plant and Equipment*	Cost	FV or cost
IAS 17 *Leases*	FV	Cost
IAS 19 *Employee Benefits* (for plan assets)	FV	FV
IAS 38 *Intangible Assets*	Cost	FV or cost[10]

[10] IAS 38 restricts the use of the fair value model to situations in which there is a quoted price in an active market for an intangible asset. As a result, the fair value model is rarely used in practice.

IFRS	Initial recognition	Subsequent measurement
IAS 39 *Financial Instruments: Recognition and Measurement*	FV	FV or amortised cost[11]
IAS 40 *Investment Property*	Cost	FV or cost
IAS 41 *Biological Assets*	FV	FV

52 Many seem to be concerned with using an exit price at initial recognition. They think it is illogical to require an entity to recognise an asset at initial recognition at the price for which the entity could sell it. They think an entry price notion is conceptually correct at initial recognition because it is the first time the entity recognises the asset or liability. This seems to relate, in part, to the different views about what a fair value should represent. When describing initial recognition, many seem to be comfortable with the notion that an asset (for example) should be measured at an entry price and have the view that it should reflect a price in an arm's length exchange (ie the 'entry' side of the current exchange price definition of fair value in IFRSs) rather than the price at which the entity can sell the asset (ie the exit price definition of fair value in SFAS 157).

53 An entity recognises an asset only once the entity has control over it or a liability only when the entity has a present obligation. IAS 39 states, 'an entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the entity' (paragraph 14). In other words, it must be a party to the contract to be able to recognise the instrument. How the entity got the asset or liability seems to be irrelevant once it has it, but many argue that applying an exit price at initial recognition seems counterintuitive. However, once an entity holds an asset or owes a liability, that entity is most concerned with what it can generate from the asset (either by use or sale) or settling/transferring the liability than what it would have to pay to acquire a new asset (which is a different asset) or receive to incur a new liability (which is a different liability).

54 When an IFRS refers to fair value for *subsequent measurement*, most seem in favour of an exit price notion. Many seem comfortable with the notion that the fair value of an

[11] Fair value must be disclosed for financial instruments and investment property even when a cost measurement is used.

asset should be based on its exit price and that it should relate to the objective, as described in SFAS 157, that fair value reflects the cash flows the asset generates through use or sale.

55 Some prefer an entry price notion for subsequent measurement, for example current replacement cost. This stems from the capital maintenance concepts in the conceptual framework.

a **Financial capital maintenance:** Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

b **Physical capital maintenance:** Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

56 Some view a current entry price as a useful input for assessing whether an entity has maintained its physical productive capacity.

Entry and exit notions do not depend on the existence of an active market

57 Many argue that an exit price notion can be applied only when there is an active market for an asset or liability. If there is no active market, they think the entity will not be able to develop a fair value measurement because the entity will need to use entity-specific assumptions.

58 Fair value reflects a current, market-based value, whether it is viewed from the buyer's or seller's perspective. The concept of an exit price can be applied whether or not a market is observable. The use of an entity's own assumptions is compatible with the

market-based view if those assumptions do not conflict with the assumptions market participants would use in pricing the asset or liability.

59 When there is no observable market data, an entity *must* start with its own assumptions (and, in the absence of information to the contrary, these assumptions will be based on what the entity thinks it would receive to sell an asset or pay to transfer a liability in an orderly transaction on the measurement date, that is the underlying cash flow generating ability of the asset or liability). The entity adjusts its own assumptions only when information is reasonably available that indicates that market participants would use different assumptions (eg if the entity receives favourable transfer pricing that would not be available to market participants).

Appendix: Other possible approaches

The staff considered two other approaches for the 'definition of fair value'.

1 **Approach 3**: define fair value as a current entry price for both initial recognition and subsequent measurement. This Approach is a combination of Approach 1 and Approach 2. The staff did not recommend this Approach because:

   a it is a hypothetical transaction price between market participants in the principal (or most advantageous) market; it is not the entity's transaction price at initial recognition.

   b it is inconsistent with SFAS 157 because it uses the words 'fair value' and defines it differently, unless the Board uses a different term (eg 'current entry price').

   c it seems to make a distinction between entry price and exit price even though there is unlikely to be a difference between them at initial recognition or for subsequent measurement.

   d it might appear counter-intuitive because it uses an entry price for an item that will generate cash by being sold or being used in the business (an 'exit' of the item, either currently or over time).

   e it might be inconsistent with the measurement objective for liabilities, which seems to be an exit price in IFRSs (a settlement amount).

2 **Approach 4**: retain the neutral exchange price definition of fair value currently in IFRSs. Each standard would specify on which market the fair value should be based. For example, a current entry price would refer to the price in the principal (or most advantageous) market in which an entity would buy the asset or incur the liability. A current exit price would refer to the price in the market in which an entity would sell it. The staff did not recommend this Approach because:

   a it is awkward and wordy when applied to existing IFRSs.

b like a current entry price, Approach 4's 'price in the market in which the entity would buy the asset or incur the liability' is a hypothetical transaction price between market participants, not the entity's transaction price.

c like Approach 2, the staff might need to develop a principle to make it operational (the principle being use the entry market at initial recognition and the exit market subsequently). This principle might be different from the Board/IASC's intentions for a particular IFRS and might be inconsistent with the measurement objective for liabilities, which seems to be an exit price in IFRSs (a settlement amount).

d it is inconsistent with SFAS 157 because it uses the words 'fair value' and defines it differently.