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INFORMATION FOR OBSERVERS

Board Meeting: **20 October 2008, Norwalk**

Project: **Fair Value Measurement**

Subject: **Project update (Agenda Paper 5A)**

Purpose of this paper

1 This paper summarises the IASB's fair value measurement project, including:

a any differences between the IASB's tentative decisions to-date and FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157); and

b potential opportunities to enhance the guidance in SFAS 157.

2 This paper is for information purposes only. The staff will not ask either board to make any decisions at this meeting.

Differences between IASB tentative decisions and SFAS 157

3 Appendix 1 contains a summary of the IASB's tentative decisions to-date on the fair value measurement project. The following table summarises the decisions that are different from SFAS 157.

Issue	SFAS 157	IASB tentative decision	Staff comment
Definition of fair value for assets	Exit price.	Exit price, and the wording of the definition will reflect the fact that an exit price considers a market participant's ability to generate economic benefit by using an asset or by selling it to a third party.	This might not result in a difference between IFRSs and US GAAP. The staff is concerned that elevating the in-use valuation premise to include it in the definition of fair value is problematic because: • the valuation premise relates to assets, not to liabilities • it might imply that the fair value of financial assets can reflect the in-use valuation premise The staff is working on a communication initiative to address this concern (see below).
Highest and best use	Silent about presentation when the highest and best use of an asset is different from the entity's current use of the asset.	The exposure draft will include descriptions of physically possible, legally permissible and financially feasible and how to apply them. An entity does not need to perform an exhaustive search to	This might not result in a difference between IFRSs and US GAAP. The 'change of use option' is a presentation issue and the staff is working on how to

Issue	SFAS 157	IASB tentative decision	Staff comment
		find other potential uses on which to base the valuation if there is no evidence to suggest that the current use of the asset is not its highest and best use. If the highest and best use of an asset is different from the entity's current use of the asset, the entity must recognise the 'change of use option' provided by the highest and best use.	operationalise this.
Blockage factors	Unit of account is individual instrument in Level 1 of the fair value hierarchy.	Unit of account is individual instrument in all levels of the fair value hierarchy.	

4 The IASB has not yet deliberated the following issues:

Issue	Expected timing of IASB meeting
Bid-ask spreads (whether there should be a practical expedient and whether bid-ask spread pricing guidance should apply at all levels of the fair value hierarchy)	October 2008
Defensive value	November 2008
Reference market	November 2008
Valuation premise	November 2008
Day one gains and losses	November 2008
Disclosures	December 2008
Measurement basis for liabilities (settlement vs. transfer) (including restrictions on transfer for assets and liabilities)	December 2008
Non-performance risk	December 2008

Potential opportunities to clarify SFAS 157 guidance

5 The staff is working on how to explain better some of the principles in SFAS 157 for which constituents have requested additional guidance. It is likely that an IFRS on fair value measurement will be different from SFAS 157 in wording, although at this stage it is not likely to be different with regard to fundamental principles. However, the IASB has not yet discussed some of the more fundamental issues (as listed in paragraph 4).

6 There are other areas for which the staff has received feedback from constituents (eg through the comment letters to the *Fair Value Measurements* discussion paper, observing the FASB's Valuation Resource Group meetings, and other means) indicating that there are some areas in SFAS 157 for which constituents have requested additional guidance. For example:

a **Unobservable (Level 3) inputs**: Many seem to find the phrase 'inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances' confusing. They interpret this to mean that the reporting entity must undertake all means possible to find market participant assumptions or to simply guess at what they would be. The staff would like to clarify that the reporting entity should begin with its own assumptions and make adjustment to those assumptions for known (or 'reasonably knowable') differences between it and market participants.

b **In-use valuation premise**: Many seem to find it difficult to reconcile the in-use valuation premise with an exit price. The staff would like to make it clear that the reporting entity should consider how market participants would use the asset and to identify any differences between how market participants would use it and how the reporting entity is using it. In many cases, the reporting entity's use of the asset will be consistent with that of market participants and the entity will be able to measure fair value assuming its current use within the business.

7 It is not ideal to use different words to describe the same concept. As the staff identifies potential rewording, it will need to make it known to the FASB and decide at that point how to proceed.

Appendix 1: IASB tentative decisions through September 2008

June 2008

1 In June 2008 the IASB clarified the scope of the fair value measurement project. The IASB reaffirmed its preliminary views for the following issues, as articulated in the *Fair Value Measurements* discussion paper:

a **single source of guidance** (Issue 1 in the discussion paper): The IASB's preliminary view was that having a single source of guidance would be an improvement over the disparate guidance in IFRSs. However, the IASB has not yet decided whether a single measurement objective should be applied to all fair value measurements. That decision will be made when the IASB discusses Issue 2A, the exit price measurement objective.

b **market participant view** (Issue 2B): The IASB's preliminary view was that the market participant view in SFAS 157 is generally consistent with the concepts of knowledgeable, willing parties in an arm's length transaction that are currently in IFRSs. However, the IASB asked the staff to consider situations in which there is no observable market for an asset or liability.

c **attributes specific to an asset or liability** (Issue 5): The IASB's preliminary view was that it is appropriate to consider attributes specific to the asset or liability that a market participant would consider when pricing the asset or liability. When location is an attribute of the asset or liability, the price in the principal (or most advantageous) market should be adjusted for costs that would be incurred to transport the asset or liability from its current location to the principal (or most advantageous) market. The IASB also had a preliminary view that transaction costs are an attribute of the transaction rather than an attribute of the asset or liability. Thus, they should be considered separately from fair value. This is consistent with current IFRSs. The IASB will address the question of 'which transaction costs to include' when it discusses bid-ask spreads.

d **the fair value hierarchy** (Issue 8): Because IFRSs do not have a consistent hierarchy that applies to all fair value measurements, the IASB favours a single hierarchy, such as the one in SFAS 157, to reduce complexity and increase comparability.

e **measuring fair value within the bid-ask spread** (Issue 10): The IASB's preliminary view was that fair value measurements should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances. However, the IASB has not decided whether it is appropriate to use mid-market pricing or another pricing convention as a practical expedient for fair value measurements within a bid-ask spread. The IASB also has not decided whether this guidance should apply only when bid and ask prices are observable in a market, or whether this concept should apply more broadly to fair value measurements in all levels of the fair value hierarchy (ie Level 1, Level 2 and Level 3 in SFAS 157).

July 2008

2 In July 2008 the IASB tentatively decided to define fair value as a current exit price. The wording of the definition of fair value will reflect the fact that an exit price considers a market participant's ability to generate economic benefit by using an asset or by selling it to a third party.

3 As a next step, the staff will complete a scope assessment for uses of fair value in current IFRSs. In situations for which the IASB decides that an exit price definition of fair value is not appropriate (eg perhaps at initial recognition), it could, for example, require an entity to use its transaction price or another measurement basis instead of fair value.

September 2008

4 In September 2008 the IASB discussed the following:

a **highest and best use**:

The IASB discussed whether a fair value measurement should reflect the highest and best use of an asset. The Board tentatively decided the following:

i The fair value of an asset should reflect its highest and best use. The highest and best use is the use by market participants that would maximise the value of the asset or of the group of assets in which the asset would be used. It considers uses of the asset that are physically possible, legally permissible and financially feasible at the measurement date. The Board tentatively decided to include in an exposure draft on fair value measurement a description of each criterion and an explanation of how they apply in a fair value measurement.

ii The exposure draft should state explicitly that an entity does not need to perform an exhaustive search to find other potential uses on which to base the valuation if there is no evidence to suggest that the current use of the asset is not its highest and best use.

iii When an entity measures an asset at fair value and currently uses the asset together with another asset in a use that differs from their highest and best use, the entity may need to split the fair value into two components: (a) the fair value of the asset assuming its current use and (b) a 'change of use option' reflecting the entity's ability to switch the asset to its highest and best use.

b **blockage factors**:

The IASB discussed whether a fair value measurement should include an adjustment for the size of an entity's holding relative to trading volume (a blockage factor). The Board confirmed its preliminary view, expressed in the discussion papers on *Fair Value Measurements* and *Reducing Complexity in Reporting Financial Instruments,* that the measurement objective should be to measure fair value at the individual instrument level. The Board tentatively decided:

i to exclude blockage factors from a fair value measurement at all levels of the fair value hierarchy.

ii that a fair value measurement should exclude other discounts or premia (such as a control premium) that apply to a holding of financial instruments and do not apply to the individual instrument.

5 The IASB also discussed disclosures about the fair value of financial instruments. The following tentative decisions were made in the context of current IFRSs as part of the Board's response to the credit crisis.

a The IASB tentatively decided to amend IFRS 7:

i to require entities to classify and disclose fair value measurements using a fair value hierarchy that is consistent with the hierarchy in IAS 39 *Financial Instruments: Recognition and Measurement*. This existing hierarchy contains the following three levels:

- Level 1: fair values measured using quoted prices in an active market for identical assets or liabilities

- Level 2: fair values measured using valuation techniques for which all inputs significant to the measurement are based on observable market data

- Level 3: fair values measured using valuation techniques for which any input significant to the measurement is not based on observable market data.

ii to require entities to present quantitative disclosures about fair value measurements in a tabular format unless another format is more appropriate to the circumstances.

iii for fair value measurement using significant unobservable inputs (Level 3), to require a reconciliation from period to period along with a narrative description about any change between levels of the hierarchy and the reasons for those changes.

iv for fair values that are disclosed but not recognised, to require an indication of the level of the hierarchy in which the instrument is classified.

b The IASB also discussed interim financial reporting. The Board noted that paragraph 15 of IAS 34 *Interim Financial Reporting* states that an entity should disclose 'At an interim date, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period'. The Board tentatively decided not to propose amendments to IAS 34.

c The IASB plans to publish an exposure draft on improving disclosures about financial instruments by the end of this year.