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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:	**February 2009, London**
Project:	**Fair Value Measurement**
Subject:	**Fair Value of Liabilities (Agenda paper 6A)**

Purpose of this paper

1. This paper discusses how to measure the fair value of a liability when there is no observable market price for the liability.

2. This paper does not address:

   a. whether fair value is the right measurement basis for liabilities. That is a question of 'when to measure a liability at fair value' and it is outside the scope of the fair value measurement project.

   b. whether to use a settlement notion instead of a transfer notion when defining the fair value of a liability. Agenda Paper 3K from the December 2008 Board meeting addressed that issue.

   c. whether including non-performance risk (credit risk) in the measurement of a liability produces decision-useful information.

   d. whether a restriction on the transfer of a liability affects its fair value. Agenda Paper 3E from the December 2008 Board meeting addressed that issue.

Summary of recommendation

3. This paper recommends the following approach to use when there is no observable price for an entity's liability:

   a. the fair value to the asset holder of the entity's obligation (for simplicity, the fair value of the 'corresponding asset') is an input that the entity should consider in estimating the fair value of its liability.

   b. the fair value of the corresponding asset is not necessarily equal to the fair value of the liability, for example if the asset includes factors that are not present in the liability.

   c. if the fair value of the corresponding asset is not directly observable, an entity would us the same thought process to estimate the fair value of the liability as it would use to estimate the fair value of the corresponding asset.

Background

4. This paper considers how to measure fair value when there is no observable market price for a liability in the context of related discussions by the Board, FASB and Valuation Resource Group (VRG).

Board discussions

5. The following table highlights tentative decisions reached by the Board regarding the measurement of liabilities.

Issue	**Tentative decision reached**
Definition of fair value	The price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date (ie the liability continues; it is not settled with the counterparty or otherwise extinguished)
Liability is not transferrable	The transaction to transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that owes the liability
Effect of restrictions	A restriction on an entity's ability to transfer a liability to a third party *does not* affect the fair value of the liability. The fair value of a liability is a function of the requirement to fulfil the obligation
No observable market	Provide guidance about how to measure fair value when there is

price for a liability	no observable market price for a liability
Non-performance risk	The fair value of a liability reflects an explicit and unbiased estimate of the effect of the non-performance risk, which is assumed to be the same before and after the transfer of the liability. Non-performance risk includes, but may not be limited to, the reporting entity's own credit risk

6. Paragraphs 38-51 of Agenda Paper 3K in December addressed the fourth issue above (ie no observable market price for a liability), noting the following:

   a. few, if any, liabilities have observable market prices on which to base a fair value measurement.

   b. if an instrument has an observable price, it is usually as an asset. For example, a debt security issued by an entity might trade on an exchange. The holders of the entity's debt security are asset holders.

   c. two views have emerged:

      i. Some think the fair value of an entity's liability is equal to the fair value of the corresponding asset.

      ii. Others think the fair value of a liability is not necessarily always equal to the fair value of the corresponding asset, but that the fair value to the asset holder is an input that the liability issuer should consider when measuring the fair value of a liability. The staff preferred the latter view.

   d. when there is no observable market price for the liability (or even for the asset), the reference market is based on the characteristics of market participants to whom the entity could transfer the liability. In those circumstances, an entity follows a building block approach for measuring the liability, as described in paragraph 17 below.

7. The pre-ballot draft circulated to the Board states the following with respect to the measurement of liabilities when there is no observable market price:

> The fair value of an entity's liability can be measured by reference to the fair value of the liability as an asset from the perspective of the asset holder (eg marketable debt securities) or by reference to the fair value of the assets available to fulfil the obligation (eg assets that would be used to fulfil a decommissioning liability).
>
> In some cases, there will be an observable market price for an entity's liability if that liability is traded as an asset. In such cases, an entity shall use that price to measure the fair value of

> its liability unless there is evidence that the price of the liability to the holder of the asset differs from the price to the obligor. Evidence that the price of the liability is not the same for both the asset holder and the obligor would be, for example, the existence of a restriction on the transfer of the asset. Such restrictions are not reflected in the fair value of a liability from the perspective of the obligor.
>
> In many cases, there will not be an observable market price to transfer a liability. In such cases, an entity shall measure the fair value of a liability on the basis of assumptions that market participants would make when considering the amount they would demand to assume the liability. As with a liability with an observable market price, the fair value of a liability to the obligor equals the fair value of the liability to the asset holder unless, for example, the fair value of the liability to the holder of the asset reflects a restriction on its transfer. A market participant transferee would be required to fulfil the obligation. Paragraphs xx-xx describe the factors a market participant transferee would take into account when measuring the fair value of a liability when there is not an observable market price.

8. Some Board members have questioned the conclusion that an entity might need to make an adjustment to the fair value of the corresponding asset when measuring the fair value of the liability. They believe that the fair value of the liability should equal the fair value of the corresponding asset in all circumstances. They would prefer that the exposure draft state that those two values are the same and ask respondents whether they agree.

FASB discussions

9. The FASB staff also are addressing the issue of how to measure fair value when there is no observable market price for a liability as they develop FASB Staff Position FAS 157-c *Measuring Liabilities under FASB Statement No. 157* (FSP FAS 157-c).

10. As currently drafted, paragraph 7 of FSP FAS 157-c states the following:

> Observable inputs into the fair value measurement of a liability shall include the quoted price for the identical liability when traded as an asset in an active market. When measuring the fair value of a liability, the measurement shall capture the elements and general principles included in paragraphs B2 and B3 of Statement 157. The fair value measurement of a liability shall not include any input (premium or discount) relating to the absence of market participants for the transfer of the liability or existence of legal restrictions preventing the transfer of the liability.

11. The FASB staff share the view expressed in Agenda Paper 3K of December that the fair value of the corresponding asset is an input that an entity should consider when measuring the fair value of its liability. They believe that the liability value might differ from the asset value in some circumstances, including when the asset value includes:

    a. the effect of transfer restrictions or

b. features such as third-party credit enhancements that are not part of the liability.

12. The FASB staff intend to present their findings to the board later this month (currently scheduled for 25 February).

VRG discussions

13. The VRG discussed FSP FAS 157-c and specifically how to measure fair value when there is no observable market price for a liability at its 5 February 2009 meeting.

14. VRG members indicated that the fair value measurement of a liability should include (as an input) the quoted price for the corresponding asset in an active market. They noted that, although fair value of the liability will equal the fair value of the corresponding asset in most circumstances, there might be circumstances when those values differ.

15. They observed that an observable price of the corresponding asset as a proxy for the liability value would not be a Level 1 input for the liability because the asset price is an exit price for the asset, not the for the liability itself.

Staff analysis

16. The fair value hierarchy prioritises inputs used to measure fair value, giving the highest priority to quoted prices in active markets for identical assets or liabilities. Few, if any, liabilities have observable market prices.

17. When there is no observable market price, an entity measures the fair value of its liability by reference to the corresponding asset value (see discussion in paragraph 18 below) or by using the building block approach, which includes:

    a. an explicit, unbiased and current estimate of the cash outflows to be paid to settle or fulfil the obligation.

    b. a current discount rate that adjusts the estimated future cash outflows for the time value of money.

    c. an explicit and unbiased estimate of the margin, if any, that a market participant would require for bearing risk arising from the obligation (a risk margin) and to generate a profit (a profit margin) related to fulfilling the obligation.

18. As noted previously, two views have emerged regarding the use of a corresponding asset value when measuring the fair value of a liability:

a. **View A**: The fair value of a liability equals the fair value of the corresponding asset in all circumstances.

b. **View B**: The fair value of the corresponding asset is an input that an entity should consider when measuring the fair value of its liability.

19. Proponents of View A believe the fair value of a liability should equal the fair value of the corresponding asset because an entity could go into the marketplace and buy the asset, thereby settling the obligation with the counterparty (setting aside (a) whether the entity has the financial resources to do so and (b) any contractual, legal, or regulatory restrictions preventing the entity from doing so). Moreover, in their view, there is no compelling reason why the asset value and liability value would diverge.

20. Proponents of View B believe that, although the liability value will equal the asset value in most circumstances, those amounts might differ in some circumstances, including those discussed in paragraph 11 above. They believe that the fair value of the corresponding asset is an input that an entity should consider when measuring the fair value of its liability. In other words, the fair value of the corresponding asset represents the starting point. An entity might need to make adjustments to that value to arrive at the fair value of the liability.

Staff recommendation and question for the Board

21. Although the staff believe that the liability value will equal the corresponding asset value in most circumstances, those amounts might differ because the asset includes factors (eg a third-party credit enhancement or transfer restrictions) that either are not present in the liability or are not reflected in measurement of the liability. Accordingly, the staff recommend that the Board state that the fair value of a corresponding asset is an input than an entity should consider when measuring the fair value of its liability in the absence of an observable market price for the liability (View B). **Does the Board agree? If not, what would the Board like to do and why?**