Project **Fair Value Measurement**

Topic **Measuring the fair value of a financial instrument**

Purpose of this paper

1. This paper addresses measuring the fair value of a financial instrument.
2. This paper asks the boards whether:
   - (a) the highest and best use concept is relevant for liabilities and financial assets
   - (b) the valuation premise concept is relevant for liabilities and financial assets
   - (c) to provide a practical expedient allowing entities to measure the fair value of a financial asset or a financial liability by considering offsetting risk positions
   - (d) to include guidance about making valuation adjustments when measuring fair value using valuation techniques.
3. In this paper, we use the term 'portfolio' to mean a unit of aggregation that has a least two financial instruments and consists of financial assets and financial liabilities which have offsetting risk positions (eg credit risk exposure to a single counterparty). It does not refer to a group of financial assets, even if those financial assets may be negatively correlated with each other.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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Summary of differences between the IASB's exposure draft and Topic 820

The highest and best use of liabilities and financial assets

4. Agenda Paper 2A (IASB)/3A (FASB) address highest and best use generally. This paper addresses whether that concept applies to liabilities and financial assets, particularly in the context of a portfolio of financial instruments.

5. Both the IASB's exposure draft *Fair Value Measurement* and FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) state that a fair value measurement considers the highest and best use of an asset. Both documents describe highest and best use as:

> The use by market participants that would maximise the value of the asset or the group of assets within which the asset would be used.

6. For financial assets and for liabilities, the IASB's concluded that:

   (a) financial assets do not have alternative uses because a financial asset can only have a different use if the characteristics of the financial asset are changed. However, this causes that particular asset to become a different asset. The objective of a fair value measurement is to measure the asset that exists at the measurement date.

   (b) because even though an entity may be able to change the cash flows associated with a liability by discharging it in different ways, the different ways of discharging a liability are not alternative uses. Moreover, although an entity might have entity-specific advantages or disadvantages that enable it to fulfil a liability more or less efficiently than other market participants, those entity-specific factors do not affect fair value.

Valuation premise for financial assets

7. Both the IASB's exposure draft *Fair Value Measurement* and FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) describe the valuation premise. Both documents describe the asset to be:

(a) 'in-use' if the asset would provide maximum value to market participants principally through its use in combination with other assets and liabilities as a group (as installed or otherwise configured for use)

(b) 'in-exchange' if the asset would provide maximum value to market participants principally on a stand-alone basis.

8. Agenda Paper 2C (IASB)/3C (FASB) discusses the valuation premise.

9. The IASB's exposure draft explicitly states that the **in-exchange valuation premise** must be used when measuring the fair value of a **financial asset**. This is because market participants would only pay for the benefits they could derive from holding the financial asset in a diversified portfolio. The exposure draft concluded that a financial asset does not derive any incremental value from being held within a portfolio.

10. Topic 820 does not explicitly state the valuation premise for financial assets. Rather, in its description of the 'in-exchange valuation premise', it states, 'The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, this **might** be the case for a financial asset' (emphasis added).

11. The use of the word 'might' in Topic 820 has been interpreted in practice to permit an in-use valuation premise for financial assets. People also have analogised the in-use valuation premise, which is written to apply to assets, to permit its application to groups of financial assets and financial liabilities. By doing this, the fair value of an individual financial instrument considers portfolio effects. This interpretation has been supported by paragraph A18 in the basis for conclusions to FASB Statement of Financial Accounting Standards No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159),[1] which states that when measuring fair value under Topic 820, the unit of valuation might differ from the unit of account.

[1] FASB Accounting Codification Topic 825 (Financial Instruments) codified SFAS 159.

Bid-ask spread

12. The bid-ask spread is relevant for portfolio valuation. Both the IASB's exposure draft and Topic 820 state that in a market where bid and ask prices are quoted, the price within the bid-ask spread that is most representative of fair value is to be used. They also contains similar guidance on when mid-market pricing or similar pricing conventions can be used as a practical expedient regardless of where the measurement is categorised within the fair value hierarchy.

13. The IASB's exposure draft proposes an amendment to IAS 39 *Financial Instruments: Recognition and Measurement* removing the bid-ask spread guidance in paragraph AG72. Paragraph AG72 of IAS 39 states:

> … When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate…

14. This paragraph was removed because it is part of the fair value measurement guidance in IAS 39 that would be superseded by a fair value measurement standard, which also addresses the issue of using mid-market prices. Thus, the guidance in IAS 39.AG72 would be redundant.

15. The IASB's rationale for including it in IAS 39 was that the entity has locked in the cash flows from the asset and the liability and could sell the matched position without incurring the bid-ask spread.

16. In IAS 39 the bid-ask spread only consists of transaction costs.

Summary of comments received on the IASB's exposure draft

17. The invitation to comment for the IASB's exposure draft asked interested parties whether the proposal that the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities was appropriate.

18. Furthermore, many respondents commented on this issue in their response to the question about convergence because the valuation premise for financial assets is included in the list of differences between the proposals in the exposure draft

and the requirements in FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157)/Topic 820 (see paragraph BC110 of the basis for conclusions accompanying the exposure draft).

The highest and best use of financial assets and of liabilities

Financial assets

19. Some respondents agree with the IASB's conclusion that financial assets do not have alternative uses. For example, although entities sometimes repackage or modify financial assets for securitisation, those activities change the characteristics of the financial assets so that they become different assets. However, others believe that a financial asset has alternative uses because it can either be combined with other instruments in a portfolio or held on its own.

Liabilities

20. Some respondents agree with the IASB's conclusion that although an entity may be able to change the cash flows from a liability by discharging it in different ways, those ways are not 'uses'.
21. However, other respondents believe that the method of discharging a liability is a different 'use'. For example, some believe that the fulfilment, extinguishment or transfer of a liability are different 'uses' for the liability. They think a 'lower of' concept would be consistent with how market participants would discharge a liability (ie they would choose the least costly means of relieving the obligation).

Valuation premise for financial assets and for liabilities

Financial assets

22. A few respondents support the proposal that the in-exchange valuation premise must be used when measuring the fair value of a financial asset because financial assets do not need other assets to generate cash flows.
23. However, nearly all respondents did not support the proposal. They are concerned that the combination of the requirement that financial assets be

measured assuming an in-exchange valuation premise and the removal of paragraph AG72 in IAS 39 prohibits the application of portfolio adjustments. They have the following concerns:

(a) the in-exchange valuation premise does not reflect how entities evaluate the risk position of a specific portfolio. They suggest that portfolio adjustments (eg for credit risk) should be permitted at 'an appropriate level of aggregation' because they think market participants would take them into consideration when closing out their risk position

(b) this would create a GAAP difference in an area where the IASB and the FASB have an objective to have converged fair value measurement guidance

(c) portfolio adjustments form part of the bid-ask spread and hence, adjusting for these under the current guidance in IAS 39.AG72 is appropriate

(d) it would change practice significantly.

Liabilities

24. Some respondents think the valuation premise concept applies to liabilities because market participants either will fulfil (in-use) or transfer (in-exchange) the obligation. They also think that market participants should be assumed to have complementary assets and/or liabilities necessary to fulfil the obligation.

Staff analysis and recommendations

25. The staff understands that there is not a difference between US GAAP and IFRS today when measuring the fair value of financial instruments. US GAAP and IFRS arrive at the same fair value, but the guidance is applied in different ways. In US GAAP, entities generally use the in-use valuation premise when measuring the fair value of a financial instrument within a portfolio (although some entities use the in-exchange premise in combination with paragraph A18 in the basis for conclusions of SFAS 159 as noted in paragraph 11 above). In IFRSs, entities use the guidance in IAS 39.AG72 about offsetting market risk

positions. Both are acceptable approaches to the valuation of a financial instrument within a portfolio. However, the boards need to develop a converged fair value measurement standard that provides a consistent approach to measuring the fair value of a financial instrument within a portfolio.

26. The following section analyses:

    (a) the highest and best use concept in terms of liabilities and financial assets

    (b) the valuation premise concept in terms of liabilities and financial assets

    (c) measuring the fair value of a financial instrument with offsetting risk positions

    (d) making valuation adjustments when measuring fair value using valuation techniques.

Is the highest and best use concept relevant for liabilities and financial assets?

27. The highest and best use concept was developed for non-financial assets. In practice it is most commonly applied to land because it can be converted to many other uses, but it remains that particular parcel of land.

28. This is different from most other assets and liabilities. Although machinery and equipment theoretically could be put to a different use than that to which it was designed, this does not happen very often in practice. However, the highest and best use concept can be applied to such assets.

29. Liabilities do not have alternative uses because:

    (a) changing the terms of a liability results in a different liability

    (b) the different ways of discharging an obligation are not different uses.

30. Financial assets do not have alternative uses because:

    (a) changing the terms of a financial asset results in a different financial asset

    (b) the different ways of combining financial assets within a portfolio are not different uses.

31. The staff recommends that a converged fair value measurement standard state that the highest and best use concept is only relevant for non-financial assets. This allows entities to avoid searching for possible alterative uses for financial assets and for liabilities.

Question 1
Do the boards agree with the staff recommendation in paragraph 31? If not, what do you propose and why?

Is the valuation premise concept relevant for liabilities and financial assets?

32. If the highest and best use concept is not relevant for financial assets or for liabilities (financial or non-financial), and the highest and best use determines the valuation premise, then it is difficult to apply the valuation premise to financial assets and to liabilities.

33. Furthermore, the valuation premise does not seem relevant for financial assets or for liabilities. The staff's analysis for liabilities and financial assets is presented in the following sections.

Liabilities

34. The intent of the valuation premise concept is to ensure that assets that derive value from being used in combination with other assets and liabilities are not measured at a scrap or liquidation value.

35. For example, a machine used in a manufacturing facility derives value from the fact that it is used with other assets. Its fair value is measured in the context of its use with those other assets (assuming it is being used according to its highest and best use). In other words, the machine has a different fair value depending on whether a market participant uses the asset with other assets or on its own.

36. This is different for a liability. A market participant transferee would not demand a different amount to assume a liability just because there are different assets backing that claim. In determining the price it will demand to assume an obligation, a market participant will take into consideration the repayment or other performance of the obligation.

37. The staff thinks the valuation premise is (a) not necessary and (b) not relevant for liabilities. Concerns about whether market participants have 'complementary assets' is addressed in the definition of market participants. Market participants are knowledgeable about the liability and have the ability to transact for it. In other words, a market participant transferee:

    (a) knows what is involved in fulfilling the obligation and

    (b) is assumed to have the ability to fulfil the obligation.

38. The staff recommends that a converged fair value measurement standard state that the valuation premise is not relevant for liabilities.

Question 2
Do the boards agree with the staff recommendation in paragraph 38? If not, what do you propose and why?

Financial assets

39. Financial assets have contractually specified cash flows. Often, they generate cash flows independently from other assets or liabilities. That is, they do not derive value from other assets or liabilities. In this way they are different from, for example, a machine within a production facility that relies on the existence of other assets within the facility to generate value. Without those complementary assets, the machine would have a scrap value.

40. Furthermore, the complementary assets concept in the in-use valuation premise does not seem to apply to financial assets. For non-financial assets, 'complementary assets' are the same assets that the reporting entity has. For a portfolio of financial instruments, although market participants do not necessarily have the same portfolio (ie with the same combination of instruments), they do have the same risk exposures.

41. Grouping financial assets does not change the expected cash flows of a particular financial asset within the group, even though those assets may be negatively correlated with each other. As a result, the in-use valuation premise concept is not applicable for financial assets.

42. If the valuation premise were relevant for financial assets, the valuation premise would be in-exchange. That is, the fair value of a financial asset is maximised by using it on a standalone basis. An entity-specific value, however, might take into account the combination of a financial asset with other assets and/or liabilities of the entity.

43. The staff thinks there are two possible approaches:

    (a) **Approach 1:** If the boards do not want to abandon the valuation premise concept for financial assets, a converged fair value measurement standard could specify that the fair value of a financial asset must be measured assuming the in-exchange valuation premise.

    (b) **Approach 2:** A converged fair value measurement standard could state that the valuation premise concept is not relevant for financial assets.

44. The next section discusses whether to provide a practical expedient to allow entities to measure the fair value of a financial asset or a financial liability by considering offsetting risk positions.

45. The staff recommends Approach 2 because:

    (a) it logically follows that if the highest and best use concept does not apply to financial assets, that the valuation premise also does not apply

    (b) it avoids trying to make the valuation premise work for financial assets when it was not developed for such assets

    (c) it prevents entities from needing to determine the valuation premise for financial assets when there is only one possible result

    (d) it will have the same result as Approach 1, but will be more conceptually appropriate.

Question 3
Do the boards agree with the staff recommendation in paragraph 45? If not, what do you propose and why?

How should an entity measure the fair value of a financial instrument when there are offsetting risk positions?

46. This section discusses whether to provide a practical expedient allowing entities to measure the fair value of a financial asset or a financial liability by considering offsetting risk positions in Levels 2 and 3 of the fair value hierarchy.

47. Discussions about the fair value measurement of a financial instrument generally centre around the unit of account. The unit of account for a financial instrument is generally the individual instrument. In practice, many financial instruments are valued on that basis.

48. However, some financial instruments are valued as part of a portfolio with offsetting risks (eg credit risk). In such situations, entities applying US GAAP and IFRSs reach the same conclusion about the fair value of a financial instrument, although they do so by taking different approaches:

    (a) In IFRSs, entities apply paragraph AG72 of IAS 39, which permits (but does not require) an entity:

        (i) to use a mid-market price for assets and liabilities with offsetting market risks when measuring fair value and

        (ii) to apply the bid or asking price to the net open position.

    (b) In US GAAP, entities use the in-use valuation premise or the in-exchange valuation premise in combination with paragraph A18 of the basis for conclusions to SFAS 159, which stated that the unit of valuation[2] might differ from the unit of account, leading entities to measure the fair value of a financial instrument within a portfolio of financial instruments at the portfolio level. This paragraph is not in the codification.

[2] The term ‘unit of valuation’ is not used in Topic 820 and is not defined in US GAAP. Generally, it means that an asset or liability can be aggregated (grouped with other assets and/or liabilities) or disaggregated for measurement purposes, even though it might be aggregated (or disaggregated) at a different level for recognition purposes.

49. The staff thinks that measuring the fair value of financial instruments in this way is a practical expedient. This is because even though the unit of account is the individual instrument, entities are measuring the instrument as part of a portfolio with offsetting risk positions. In this case, the fair value measurement is not applied to each of the individual instruments, but to the offsetting position, which is comprised of a group of instruments. The resulting fair value measurement is market-based in that it considers what a market participant would consider in determining a price it is willing to pay for the same net risk exposure.

50. Paragraph AG72 of IAS 39 refers to 'offsetting market risks'. In practice, 'market risk' has been interpreted to include credit risk in IAS 39. Constituents have asked the IASB to confirm that this practice is appropriate given that both market risk and credit risk are defined in IFRS 7 *Financial Instruments: Disclosures*, implying that they are two separate types of risk (the definitions are in the appendix to this paper).

51. The staff thinks the market risk referred to in paragraph AG72 of IAS 39 includes credit risk because a market participant would take it into consideration when pricing the instrument.

52. The staff recommends that a converged fair value measurement standard include a practical expedient allowing entities to measure the fair value of a financial asset or a financial liability by considering offsetting market risk positions, including credit risk. That guidance would emphasise that the valuation must be consistent with the objective of fair value measurement.

Question 4
Do the boards agree with the staff recommendation in paragraph 52? If not, what do you propose and why?

Making valuation adjustments in a fair value measurement using valuation techniques

53. When measuring the fair value of a financial instrument when there is not a quoted price for that instrument (ie when using a valuation technique), an entity might need to make valuation adjustments.

54. The staff thinks the discussions held by the IASB's Fair Value Expert Advisory Panel in 2008 are helpful. The Expert Advisory Panel's report, *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*, discussed valuation adjustments for financial instruments. Although the report addresses valuation when markets are no longer active, these concepts are relevant in any market environment.

55. The Expert Advisory Panel report states that valuation adjustments might be needed when a model does not properly estimate the price at which an orderly transaction would take place between market participants on the measurement date. It provided the following examples of adjustments that might be made:

    (a) **model adjustments:** if there is a known deficiency or if calibration has highlighted a deficiency, the model is adjusted to take it into account

    (b) **liquidity adjustments:** if the model calculates a mid-market price, it is adjusted to take into account the relevant bid-offer spread

    (c) **credit risk adjustments:** if the model does not take into account counterparty or own credit risk, it is adjusted accordingly

    (d) **other risk adjustments:** if the model does not take into account a risk premium that market participants would take into consideration in pricing the transaction (eg a risk premium relating to the complexity of valuation of an instrument), it is adjusted accordingly.

56. It is important that any adjustments are consistent with the objective of fair value measurement; that is, it must reflect the price at which an orderly transaction would take place between market participants on the measurement date. An entity should only take into account the adjustments market participants would make to price the financial instrument under current market conditions.

57. The staff recommends that a converged fair value measurement standard:

    (a) describes the type of valuation adjustments that entities might need to make in a fair value measurement, without being overly prescriptive

(b) states that any valuation adjustments must be consistent with the objective of fair value measurement. That is, an entity includes only those adjustments that market participants would make when pricing the asset or liability under current market conditions.

Question 5
Do the boards agree with the staff recommendations in paragraph 57? If not, what do you propose and why?

Appendix – Definitions of market risk and credit risk in IFRS 7

credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk**, **interest rate risk** and **other price risk**.
other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from **interest rate risk** or **currency risk**), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.