Project **Fair Value Measurement**

Topic **Market participant view**

Purpose of this paper

1. This paper addresses the market participant view in a fair value measurement.

2. This paper asks the boards to:

   (a) confirm that fair value is a market-based measurement, not an entity-specific measurement

   (b) clarify the level of knowledge market participants are assumed to have about an asset or liability

   (c) clarify the meaning of 'independence' and address whether transactions with related parties should be excluded from a fair value measurement even when they are entered into at arm's length

   (d) clarify the approach for developing market participant assumptions when observable data is not available (ie in Level 3 of the fair value hierarchy).

3. This paper contains the following appendices:

   (a) Appendix A compares the proposed definition of market participants in the IASB's exposure draft with the definition in FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures)[1]

   (b) Appendix B compares the IFRS and US GAAP definitions of related parties.

4. The boards have already had detailed technical discussions on this topic in developing the IASB's exposure draft and FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157). As a result, the meeting will focus on analysing the differences between those two documents, the comments received on the IASB's proposals and feedback received about the implementation of Topic 820. This paper does not replicate the analyses already discussed by the boards in developing the IASB's exposure draft and SFAS 157/Topic 820. Board members should contact the staff for the relevant background materials if needed.

Overview of comments received on the IASB's exposure draft

5. The invitation to comment for the IASB's exposure draft asked interested parties whether the proposed description of market participants is adequately described.

6. Most respondents agreed with the definition of market participants. However, some are concerned with some aspects of the proposed definition. For example:

   (a) they would prefer a fair value measurement that reflects an entity's view rather than a market participant's view;

   (b) they would like clarification about the relative level of knowledge of market participants;

[1] Topic 820 codified Statement of Financial Accounting Standards No. 157 *Fair Value Measurements*.

(c) there are questions about what it means to be independent and whether a fair value measurement can be based on arm's length transactions between related parties; and

(d) they think it is inconsistent to start with an entity's own data in Level 3 and still describe it as a market-based measure.

Staff analysis and recommendation

Fair value reflects a market participant view

7. In the comment letters, some respondents stated that fair value should not reflect market participant assumptions but rather those of the entity. These respondents argue that an entity is more knowledgeable about the cash flows of an asset or liability than a hypothetical market participant would be. They believe that management's estimates of future cash flows are more indicative of the 'true fair value' of that asset or liability.

8. Others believe that an entity should be allowed to use its own assumptions (rather than market participant assumptions) in a fair value measurement only when markets are illiquid.

Staff analysis and recommendation

9. When deliberating their respective documents, both boards decided that market participant assumptions appropriately capture the uncertainty about the amount and timing of future cash flows and are relevant for a fair value measurement. As a result, both the IASB's exposure draft and Topic 820 emphasise that a fair value measurement is a market-based measurement, not an entity-specific measurement.

10. Paragraph 35 in FASB Concept Statement No. 7 *Using Cash Flow Information and Present Value in Accounting Measurements* provides the following argument for using a market participant perspective in measuring fair value:

> Among their many functions, markets are systems that transmit information in the form of prices. Marketplace participants attribute

> prices to assets and, in doing so, distinguish the risks and rewards of one asset from those of another. Stated differently, the market's pricing mechanism ensures that unlike things do not appear alike and that like things do not appear to be different (a qualitative characteristic of accounting information). An observed market price encompasses the consensus view of all marketplace participants about an asset or liability's utility, future cash flows, the uncertainties surrounding those cash flows, and the amount that marketplace participants demand for bearing those uncertainties.

11. The staff recommends that the boards confirm that a fair value measurement is market-based and reflects the assumptions that market participants would use in pricing the asset or liability.

Question 1 – Fair value reflects a market participant view
Do the boards agree that a fair value measurement reflects a market-based view, that is, the assumptions that market participants would use in pricing the asset or liability? If not, what do you propose and why?

The relative level of knowledge of market participants

12. In its exposure draft, the IASB proposed that a market participant is sufficiently informed to make an investment decision and is presumed to be as knowledgeable as the reporting entity about the asset or liability. This level of knowledge was assumed because many respondents to the IASB's discussion paper *Fair Value Measurements* in November 2006 (a wrap-around of SFAS 157) had questions about how much knowledge they could assume that market participants have about the characteristics of an asset or liability.

13. Rather than allowing entities to 'cherry pick' the characteristics (attributes) of the asset or liability that market participants may or may not know about, the IASB decided to propose that market participants and the reporting entity are equally knowledgeable. In other words, even though the reporting entity and the market participant are presumed to be equally knowledgeable about the asset or liability, neither party is perfectly knowledgeable (ie the uncertainty an entity faces because it does not have perfect knowledge about the timing and amount

of future cash flows). In other words, a fair value measurement does not reflect information asymmetry, but rather information uncertainty.

14. Topic 820 states that market participants have a reasonable understanding of the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.

15. Some respondents agree with the IASB's proposal. They find it helpful and practical because it alleviates their concerns about what to assume market participants know. Furthermore, some note that in a business combination, the acquiring entity is often indemnified against losses due to the seller not providing relevant information (although this might not always be the case, and might not apply in some jurisdictions).

16. However, other respondents are concerned about the level of knowledge that market participants should be presumed to have, given that the reporting entity might have access to information that is not available to other market participants.

17. These respondents think it is not realistic to assume that a market participant has as much information as the reporting entity. They assert that information asymmetry is an understood reality in transactions, and that market participants enter into a transaction accepting the asymmetry of information. They believe that the IASB's proposed description of 'knowledgeable' assumes that market participants have access to the 'insider' information even though that information is not available to the public. They believe that this will result in differences between observable market prices and fair value measurements solely because observable market prices do not capture 'insider' information.

Staff analysis and recommendation

18. The staff agrees with the argument that information asymmetry exists in observable market prices, that these prices may reflect discounts or premiums for information asymmetry and that it would be unrealistic to assume otherwise. The staff thinks it is sufficient for a market participant to be reasonably

knowledgeable (based on all available information and customary due diligence efforts) when determining a fair value.

19. Therefore, the staff recommends that the boards describe ‘knowledgeable’ as having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.

Question 2 – Relative level of information
Do the boards agree that market participants should be assumed to have a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary? If not, what do you propose and why?

The meaning of independence

20. The IASB’s exposure draft describes market participants as *independent of each other*. That is, market participants (including the reporting entity) are not related parties (Appendix B compares the IFRS and US GAAP definitions of related parties). This is meant to address both of the following situations:

    (a) when using data from transactions between the reporting entity and another party, the other party and the reporting entity must be independent of each other

    (b) when using observable data from transactions between other parties, the parties to the transaction are independent of each other.

21. Topic 820 describes market participants *independent of the reporting entity*. That is, the market participant and the reporting entity are not related parties. This addresses the situation in (a) above, although the staff believes that the FASB’s intent was to include (b) as well.

22. The IASB’s proposed guidance focuses on the interaction between the market participants rather than the reporting entity’s relationship with the market participants. This is because the objective of a fair value measurement is to

estimate a price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (*not between the reporting entity and a market participant*) at the measurement date.

23. Many respondents agree with the IASB proposal that if a fair value measurement uses market participant assumptions, those market participants should *be independent from each other*.

24. However, some respondents are concerned about the perceived prohibition on using information from related party transactions, particularly in jurisdictions where many entities are state owned enterprises (in both the IASB's exposure draft and in Topic 820). They think that transactions between related parties must be ignored as inputs in a fair value measurement, even if these transactions were at arm's length.

Staff analysis and recommendation

25. A fair value measurement assumes a transaction between market participants. Therefore, it is important that the final standard is clear that a market participant is independent from the reporting entity when the entity uses its own data as a starting point to estimate fair value. It is equally important that the standard be clear that market participants be independent from each other when the reporting entity observes market transactions.

26. The staff think that describing market participants as *independent from each other* captures this intention adequately. That is because even when an entity uses its own data as a starting point to measure fair value, it will make the necessary adjustments to the data to reflect market participant assumptions.

27. The staff thinks that it was not the boards' intention to preclude an input from a fair value measurement simply because the parties that entered into a particular observable transaction were related. Describing a market participant as independent (not a related party) ensures that the reporting entity does not include any assumptions derived from a special relationship that might exist between related market participants. However, observable inputs derived from transactions between related market participants that have occurred at arm's

length do not, by definition, contain any considerations about their ‘special’ relationship. The staff thinks such an input could be used in measuring fair value.

28. Therefore, the staff recommends that

    (a) the fair value measurement standard state that market participants are *independent of each other*, that is, they are not related parties.

    (b) the boards clarify that observable inputs may include transactions between related parties if they were entered into at arm’s length.

Question 3.1 – The meaning of independence
Do the boards agree that the description of market participants as *independent of each other*; that is, they are not related parties, is appropriate? If not, what do you propose and why?

Question 3.2 – Arm’s length transactions
Do the boards agree that a relevant price in a related party transaction may be used as an input to a fair value measurement when the transaction was entered into at arm’s length? If not, what do you propose and why?

Using Level 3 inputs in a fair value measurement

29. Some respondents interpret the IASB’s proposed guidance and the requirements in Topic 820 to mean that if observable data is not available, an entity measures fair value using hypothetical information that hypothetical market participants would consider. This raises the concern of how an entity is meant to know what others would assume, particularly in industries that operate with highly specialised assets or liabilities.

Staff analysis and recommendation

30. The IASB’s exposure draft proposes an approach that is based on the principle in Topic 820 (when observable inputs are not available, an entity uses

unobservable inputs based on market participant assumptions). Both the exposure draft and Topic 820 state that the objective of a fair value measurement is the same regardless of the level of the hierarchy. The staff thinks this is clear and does not recommend changing that focus.

31. However, the description in the IASB's exposure draft about the process of developing market participant assumptions is different from the description in Topic 820. The IASB's exposure draft states that an entity may begin with its own data, but that data must be adjusted if there is reasonably available information that indicates that:

    (a) other market participants would use different data; or

    (b) there is something particular to the entity whose details are not available to other market participants (eg an entity-specific synergy).

32. Topic 820 states that unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions.

33. Many respondents think the IASB's proposed approach is more practical than the approach articulated in Topic 820 because the proposed guidance makes it clear that the reporting entity does not need to estimate hypothetical information when there are no observable data. The staff recommends that the converged fair value measurement standard articulate the approach as proposed in the IASB's exposure draft.

Question 4 – Perceived inconsistency between market participant assumptions and unobservable inputs
Do the boards agree that the unobservable inputs derived from an entity's own data, adjusted for any information that market participants would take into account, are considered market participant assumptions and meet the objective of a fair value measurement? If not, what do you propose and why?

Appendix A – Description of market participants proposed in the IASB's exposure draft and in Topic 820

Reference	IASB's Exposure Draft	Reference	Topic 820
Paragraph 13	Market participants are buyers and sellers in the most advantageous market for the asset or liability that are:	820-10-20 (Glossary)	Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
	(a) independent of each other,[2] ie they are not related parties (as defined in IAS 24 *Related Party Disclosures*);		(a) Independent of the reporting entity (that is, they are not related parties)
	(b) knowledgeable, ie they are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability;		(b) Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary
	(c) able to enter into a transaction for the asset or liability; and		(c) Able to transact for the asset or liability
	(d) willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.		(d) Willing to transact for the asset or liability (that is, they are motivated but not forced or otherwise compelled to do so).

[2] The reporting entity is a market participant, but it is not the only market participant to consider when measuring fair value.

Paragraph 14	The fair value of the asset or liability shall be measured using the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, an entity need not identify specific market participants. Rather, the entity shall identify characteristics that distinguish market participants generally, considering factors specific to:	820-10-35-9	The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to all of the following:
	(a) the asset or liability,		(a) The asset or liability
	(b) the most advantageous market for the asset or liability; and		(b) The principal (or most advantageous) market for the asset or liability
	(c) market participants with whom the reporting entity would enter into a transaction in that market.		(c) Market participants with whom the reporting entity would transact in that market.

Appendix B – Definitions of related parties in IFRSs and US GAAP

Reference	**IAS 24 *Related Party Disclosures***	**Reference**	**Topic 820**
Paragraph 9	A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity'). (a) A person or a close member of that person's family is related to a reporting entity if that person: (i) has control or joint control over the reporting entity; (ii) has significant influence over the reporting entity; or (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. (b) An entity is related to a reporting entity if any of the following conditions applies: (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others). (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which	Master Glossary	Related parties include: (a) Affiliates of the entity (b) Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825–10–15, to be accounted for by the equity method by the investing entity (c) Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management (d) Principal owners of the entity and members of their immediate families (e) Management of the entity and members of their immediate families (f) Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

	the other entity is a member). (iii) Both entities are joint ventures of the same third party. (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity. (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity. (vi) The entity is controlled or jointly controlled by a person identified in (a). (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).		(g) Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.