Project	**Fair Value Measurement**
Topic	**Reference market**

Purpose of this paper

1. This paper addresses the guidance on determining the market that should be used to measure fair value (referred to as the 'reference market').

2. This paper asks the boards to:

   (a) decide whether to use the principal (or most advantageous) market notion in FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) or the most advantageous market notion in the IASB's exposure draft *Fair Value Measurement*

   (b) clarify whether 'the volume and level of activity' relates to the entity's trading activity or the trading activity of the asset or liability in the reference market

   (c) clarify that the principal market is the market in which the entity normally transacts

   (d) clarify whether transportation costs are included in the most advantageous market determination.

3. 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).[1] As a

[1] FASB Accounting Standards Codification Topic 820 codified SFAS 157.

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.

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

IASB exposure draft

4. The IASB's exposure draft states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the *most advantageous market* to which the entity has access. The most advantageous market is defined in the exposure draft as:

> The most advantageous market is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs.

5. The IASB's exposure draft also states that in the absence of evidence to the contrary, an entity may assume that the *principal market* for the asset or liability is the most advantageous market, provided that the entity can access the principal market. The principal market is defined in the exposure draft as:

> The principal market is the market with the greatest volume and level of activity for the asset or liability.

6. In addition, the IASB's exposure draft states that an entity need not undertake a search of all possible markets to identify the most advantageous market. The market in which the entity would normally enter into a transaction is presumed to be the most advantageous market.

Topic 820

7. Topic 820 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the *principal market* for the asset

or liability, or in the absence of a principal market, occurs in the *most advantageous market* for the asset or liability.

8. The master glossary in the Accounting Standards Codification defines the principal market and the most advantageous market as:

> The *principal market* is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability.
>
> The *most advantageous market* is the market in which the reporting entity would sell an asset or transfer a liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s).

Overview of comments received on the IASB's exposure draft

9. The invitation to comment for the IASB's exposure draft asked interested parties whether the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access is appropriate when measuring fair value.

10. Some respondents agree with the proposal to base a fair value measurement on the price in the most advantageous market for the asset or liability. They think that profit-maximising entities will transact in the most advantageous market.

11. However, some find the guidance confusing. They think it is unclear whether the most advantageous market must be used, or if the principal market simply represents the most advantageous market. They also find it unclear how the market in which the entity normally transacts relates to the principal and most advantageous markets.

12. Some respondents are concerned that using the most advantageous market introduces an upward bias into the measurement. They prefer the principal market because it is unbiased. Furthermore, some think the market with the most activity will be more liquid and therefore provide a more representative estimate of fair value.

13. Many respondents are concerned about the lack of convergence with US GAAP on this point. However, they are not sure there would be a significant difference

in fair values whether they are measured using the most advantageous market or the principal market.

14. Some respondents think that the exposure draft does not provide sufficient guidance on what to do where there is no observable market (whether principal or most advantageous). Their primary concern is with how to measure a market-based fair value by reference to a price in a hypothetical market. This is also a concern with Topic 820, and the IASB exposure draft states that if there is not an observable market, an entity considers the characteristics of market participants who would transact for the asset or liability.

Staff analysis

Possible reference markets

15. The staff observes that, conceptually, the guidance in Topic 820 and the IASB's exposure draft about the reference market to use to measure fair value is similar. In prior deliberations, both boards concluded that the objective of most entities is to maximize profits. As a result, both boards concluded that entities would generally choose to transact in the most advantageous market to which the entity could access at the measurement date.

16. The staff also observes that both boards have concluded that the principal market for the asset or liability is often also the most advantageous market. The IASB's exposure draft states:

> In the absence of evidence to the contrary, an entity may assume that the principal market for the asset or liability is the most advantageous market, provided that the entity can access the principal market.

The basis for conclusions in Statement 157, *Fair Value Measurements,*[2] states:

> The Board [FASB] clarified its view that generally the principal market for an asset or liability (parenthetical omitted) will represent the most advantageous market for the asset or liability.

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

17. The basis for conclusions in Statement 157 also states that the FASB developed the principal (or most advantageous) market notion to clarify that its intent was not to require that entities continuously search across all possible markets in which transactions for the related asset or liability can be observed for the most advantageous price for the asset or liability

18. The IASB addressed this by stating that an entity need not monitor all possible markets to determine which market is most advantageous at the measurement date. It is presumed that an entity would normally transact in the most advantageous market. Some respondents to the IASB's exposure draft are concerned that this language requires (a) the entity to prove that it performed a sufficient search for the most advantageous market and (b) the auditor to determine whether the entity performed a reasonable search by performing its own comprehensive search.

19. Forms of both reference market notions are currently required in US GAAP and in other IFRSs. As previously discussed, Topic 820 requires the use of the principal (or most advantageous) market notion for all fair value measurements within its scope.

20. IAS 39 *Financial Instruments: Recognition and Measurement* contains a most advantageous market notion when measuring fair value for a financial instrument that is traded in an active market. Paragraph AG 71 states:

> The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument… in the most advantageous active market to which the entity has immediate access.

21. The basis for conclusions in IAS 39 states that the IASB meant to clarify how to measure fair value when an entity operates in more than one market. In such situations, the entity uses the price in the most advantageous active market to which the entity has immediate access. For example, a trader might originate a derivative with a corporate in an active corporate retail market and offset the derivative by taking out a derivative with a dealer in an active dealers' wholesale market. If the dealer enters into a derivative instrument with the corporate, but has immediate access to a more advantageously priced dealers'

market, the dealer recognises a profit on initial recognition of the derivative instrument.

22. IAS 41 *Agriculture* contains a most relevant market notion. The most relevant market is the market expected to be used by the entity. The basis for conclusions in IAS 41 provides the reason for the IASB's decision:

> When an entity has access to different markets, the [IAS 41] indicates that the entity uses the most relevant one. For example, if an entity has access to two active markets, it uses the price existing in the market expected to be used. Some believe that the most advantageous price in the accessible markets should be used. [IAS 41] reflects the view that the most relevant measurement results from using the market expected to be used.

23. The staff believes that the reference market notions in Topic 820 and IAS 39 both are operational. The staff is not aware of any significant practice issues about determining the reference market when measuring fair value under either Topic 820 or IAS 39. In fact, some respondents to the IASB's discussion paper *Fair Value Measurements* (published in November 2006) stated that they did not share the concerns of entities in the US that the most advantageous market notion causes them to continuously monitor multiple markets. They stated that they already have the systems in place to do this.

24. The staff thinks the principal and most advantageous market notions in Topic 820 and IAS 39 are preferable to the most relevant market notion in IAS 41. Using a most relevant market notion as a principle could result in inconsistent application.

Clarifications

Volume and level of activity

25. The staff is aware of different interpretations in practice related to the guidance in Topic 820 for selecting the principal market.

26. Topic 820 states that the principal market is the market in which the reporting entity would sell the asset or transfer the liability *with the greatest volume and level of activity for the asset or liability* (emphasis added).

27. Some believe that this language refers to the entity's own trading activity in the market. That is, the principal market is the market in which the entity has the greatest level of trading activity. Others interpret this to mean the principal market is the market with the greatest level of trading activity for the asset or liability in the market generally, not to a specific entity. In other words, some interpret the market as the principal market *for the entity*; others interpret the market as the principal market *for the asset or liability*.

28. The staff thinks that it is likely that the principal market for the entity and the principal market for the asset or liability will be the same. However, there will be situations when they are not the same.

29. Consider the following example. Entity A holds shares in a publicly traded company. The shares are traded on the New York Stock Exchange (NYSE). Entity A acquired the shares in a private transaction with another party. Entity A has not transacted and does not plan to transact on the NYSE. The market with the greatest volume and level of activity *for the shares* is the NYSE. The market with the greatest volume and level of activity *for the entity* is the principal-to-principal market. Depending on their interpretation of Topic 820, an entity might use either market.

30. The staff thinks the FASB's intent was that the entity would use the price on the NYSE. That is, the principal market is the market with the greatest volume and level of trading activity for the asset or liability (not for the entity). Selecting the principal market based on the market with the greatest level of trading activity for the asset or liability results in a fair value measurement based on the most liquid market price for the asset or liability.

31. Even though Entity A does not intend to transact on the NYSE, the fair value measurement using the NYSE price provides a useful benchmark. When Entity A eventually does transact in a market other than the principal market, Entity A's advantages or disadvantages relative to the market will be evident.

The market in which the entity normally transacts

32. If the boards pursue a principal market notion with the clarification about the volume and level of activity, the staff thinks there might be concerns about

searching for the market with the greatest volume and level of activity (ie the same concern that has been expressed about the most advantageous market).

33. The IASB's exposure draft states that the market in which the entity would normally enter into a transaction is presumed to be the [reference] market. The staff thinks this is appropriate because in the absence of evidence to the contrary an entity is likely to transact in the market with the greatest volume and level of activity.

34. This also prevents entities from needing to perform an exhaustive search for other markets with more activity. Even though this puts the onus on the entity to perform a search for the market with the greatest volume and level of activity, the staff thinks an entity would be aware of the market with the greatest volume and level of activity for the assets and liabilities it has. In other words, it is unlikely that there would be a market for an entity's assets or liabilities that the entity is not aware of.

35. 'Evidence to the contrary' includes the situation in the example in paragraph 29. In that example there is an active market for the asset even though the entity does not intend to transact in that market. In this example it likely that the entity would be aware of the existence of that other market (the NYSE).

36. The staff thinks it is necessary to include a rebuttable presumption to address situations when the trading activity for the asset or liability is not the same as the trading activity for the entity to ensure that application of the principle is consistent with the boards' intent.

Transportation costs

37. The staff is aware of a difference between the definition of *most advantageous market* in Topic 820 and in the IASB's exposure draft related to transportation costs. The IASB's definition of most advantageous market states that both transaction and transportation costs should be considered when determining the most advantageous market. Topic 820 only requires consideration of transaction costs when determining the most advantageous market.

38. The staff believes that the determination of the most advantageous market should consider both transaction costs and transportation costs. The staff

recommends that the boards clarify their intent as to whether both transaction costs and transportation costs should be considered when determining the most advantageous market.

Staff recommendation

39. The staff recommends that the boards use the principal (or most advantageous) market notion in Topic 820, with the following clarifications:

    (a) the principal market is the market with the greatest volume and level of activity for the asset or liability. It is not based on the entity's level of trading activity in a market

    (b) there is a presumption that the principal market is the market in which the entity normally transacts

    (c) the determination of the most advantageous market considers both transaction costs and transportation costs.

40. The staff believes that the principal (or most advantageous) market notion:

    (a) best represents the boards' intent to measure fair value based on an entity's rational economic behavior to maximize profits;

    (b) results in more liquid, and therefore more representative, inputs for a fair value measurement; and

    (c) it addresses concerns from some constituents regarding the operational challenge of continuously searching for the most advantageous market.

Question 1 – Guidance about reference markets for fair value measurements
Do you agree with the staff recommendation to use the principal (or most advantageous) market notion? If not, what do you propose and why?

Question 2 – Clarification about whether the volume and level of activity relates to the entity's activity or the activity of the asset or liability generally
Do you agree with the staff recommendation to clarify that the principal market is the market with the greatest volume and level of activity for the asset or liability? If not, what do you propose and why?

Question 3 – Clarification about whether the principal market is the market in which the entity normally transacts
Do you agree with the staff recommendation to include a rebuttable presumption that the principal market is the market in which the entity normally transacts? If not, what do you propose and why?

Question 4 – Clarification about whether transportation costs are included in the most advantageous market determination
Do you agree with the staff recommendation to clarify that the determination of the most advantageous market considers transportation costs? If not, what do you propose and why?