



Project	Fair Value Measurement
Topic	Measuring fair value when markets become less active

Purpose of this paper

1. This paper addresses the guidance for measuring fair value when markets become less active. Both the IASB's exposure draft *Fair Value Measurement* and FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) provide guidance for this situation.¹
2. In addition, the IASB's Fair Value Measurement Expert Advisory Panel published a report on this topic with regard to financial instruments in October 2008 (*Measuring and disclosing the fair value of financial instruments in markets that are no longer active*). The IASCF has published the Expert Advisory Panel report (and the accompanying IASB Staff Summary about using judgement to measure the fair value of financial instruments when markets are no longer active) as educational material.
3. This paper asks the boards to:
 - (a) clarify whether the guidance for measuring fair value in markets that are not active should focus on when:
 - (i) there has been a significant decline in the volume and level of activity for an asset or liability or

¹ The guidance in Topic 820 was originally published as FASB Staff Position FAS 157-4 *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*.

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.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

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Staff paper

- (ii) the market for an asset or liability has always been inactive.
 - (b) decide whether to include some or all of the IASB's Expert Advisory Panel report in a standard on fair value measurement guidance.
- 4. In a future meeting the staff will address disclosures about fair values when markets are no longer active.

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

- 5. The IASB's exposure draft applies to two situations:
 - (a) when there has been a significant decline in the volume and level of activity for the asset or liability and
 - (b) when the market for an asset or liability has always been inactive (ie there have not been Level 1 price inputs in the past).
- 6. Topic 820 focuses on the situation in paragraph 5(a).
- 7. 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).² As a result, this 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.

² FASB Accounting Standards Codification Topic 820 codified SFAS 157.

Overview of comments received on the IASB's exposure draft

Focus of the guidance for measuring fair value when markets become inactive

8. The invitation to comment for the IASB's exposure draft asked interested parties whether the guidance on valuation techniques, including specific guidance on markets that are no longer active is appropriate and sufficient.³ (This topic was also discussed at the round-table meetings.)
9. Respondents generally support the inclusion of the guidance for measuring fair value in markets that are no longer active (paragraphs B5-B15 and IE29-IE38 of the IASB's exposure draft). Some do not see the need for further guidance and believe that the guidance provided is appropriate and sufficient.
10. However, some respondents prefer the focus in Topic 820 on the situation in paragraph 5(a) above. They think the situation in paragraph 5(b) does not need specific guidance: if there has not been an observable price in an active market for an asset or liability in the past, market participants have developed valuation techniques for measuring the fair value of such items.

Including aspects of the IASB's Expert Advisory Panel report

11. Some respondents suggest including some or all of the Expert Advisory Panel report in the fair value measurement standard. They find the material in that report to be helpful in practice and find the structure and wording used to be preferable to the wording in Topic 820 and the IASB's exposure draft (generally because they think it is principles-based).
12. However, others think the Expert Advisory Panel report should not be incorporated into a fair value measurement standard because:
 - (a) it addresses only financial instruments, and would need to be generalised for other assets or liabilities for which there is pricing information (eg commodities, real estate)

³ Although the question in the invitation to comment pertained to valuation techniques generally, the comment letters did not indicate concerns with the valuation techniques described in the exposure draft (and in Topic 820), although some had drafting suggestions.

Staff paper

- (b) it is a summary of practice as articulated by the panel participants
 - (c) it would date the standard because the report focuses only on the valuation of the specific types of instruments highlighted in the financial crisis.
13. Some are concerned that taking parts of the Expert Advisory Panel report out of context might lead to confusion about how to apply the thought process to non-financial assets and liabilities, reducing the value of the document.
 14. At a minimum, some ask that the IASB clarify that the Expert Advisory Panel report can still be referred to for guidance.
 15. Some respondents are concerned about the requirement to place less weight on transactions for which the entity does not have sufficient information to conclude they are not orderly. They note that in many cases an entity will not be able to obtain detailed information about the transactions of other entities and as a result entities will be able to ignore orderly transactions with undesirable prices.
 16. Some respondents think there is a risk that the indications of when a market is no longer active (paragraph B5 of the IASB's exposure draft and paragraph 820-10-35-51A of Topic 820) and the factors indicating when transactions are no longer orderly (paragraph B11 of the IASB's exposure draft and paragraph 820-10-35-51E of Topic 820) will be read as a complete list of the only circumstances in which a market can be deemed to be inactive or a transaction not orderly. The staff will consider this in drafting.
 17. Some suggest wording changes for and clarification about the indications of when a market is no longer active and for the factors indicating when transactions are no longer orderly. For example, some respondents noted that a few of the indications of when a market is no longer active are observed in active markets as well. The staff will consider these in drafting.
 18. Some have indicated that when markets are no longer active, fair value is not a reliable measurement basis. They suggest using a different measurement basis in such situations. Because this project does not dictate *when* fair value is used, the staff does not address that issue in this paper.

Staff recommendation

Focus of the guidance for measuring fair value when markets become inactive

19. The staff thinks the guidance in (and the focus of) Topic 820 is more helpful than in the IASB's exposure draft. In particular, this guidance is intended to be targeted toward entities measuring the fair value of an asset or liability when there has been a significant decline in the volume and level of activity for the asset or liability regardless of whether it used to trade in an active or inactive market.
20. The FASB specifically considered this issue when deliberating FSP FAS 157-4. Respondents to the exposure draft preceding the FSP noted that the previous level of trading activity was not the issue—they needed guidance for any situation in which the level and volume of trading activity for an asset has declined significantly (eg during the financial crisis), even when the asset had always been traded in an inactive market. The FASB decided that the scope of the FSP was appropriate for all assets and liabilities for which the volume and level of activity have significantly decreased, regardless of the previous level of trading activity.
21. Therefore, the staff recommends that the fair value measurement standard focus on when there has been a significant decline in the volume and level of activity for the asset or liability. In those circumstances, the guidance in Topic 820 states that an entity needs to perform additional analysis to determine whether a significant adjustment to an observable input is necessary or whether other valuation techniques should be used to measure fair value.

Including aspects of the IASB's Expert Advisory Panel report

22. The staff suggests not including the Expert Advisory Panel report *in its entirety* for the reasons in paragraph 12 and for the following reasons:
- (a) it is available as educational material to those interested in referring to it
 - (b) it addresses financial instruments, and is not suitable for a document that addresses all types of assets and liabilities measured at fair value. It would be difficult to revise the document to make it applicable more generally because the purpose behind it (that is, a summary of practice in the financial crisis) would be lost
 - (c) most of the information in the report is already included in Topic 820 and the IASB's exposure draft because it was taken into consideration in the drafting of FSP FAS 157-4 (and was implicit in IAS 39 *Financial Instruments: Recognition and Measurement*)⁴
 - (d) it focuses on a particular economic situation.
23. However, there are aspects of Expert Advisory Panel report that would be useful. The staff therefore recommends that the following concepts be incorporated into a fair value measurement standard:
- (a) There is no bright line between an active and an inactive market. The issue is whether an observed transaction price represents fair value, not about the level of market activity (although changes in market activity may be an indication that an observable price does not represent fair value, and that an entity may need to make further efforts to determine fair value). The IASB's exposure draft and Topic 820 do not address this explicitly.

⁴ Because the Expert Advisory Panel discussions were in the context of applying the relevant accounting literature (both US GAAP and IFRSs), any amendments to the accounting literature (eg FSP FAS 157-4) did not result in changes to the principle. They were meant to help entities having trouble with applying judgement when measuring fair value in that economic environment.

Staff paper

- (b) An entity should consider observable transaction prices unless there is evidence that the transaction was forced. This is different from the focus in Paragraph B14 of the IASB's exposure draft (paragraph 820-10-35-51F in Topic 820), which states that an entity shall place less weight on transactions for which the entity *does not have sufficient information* to conclude they are not orderly.⁵ This could result in entities ignoring transaction prices that they deem to be undesirable. The staff thinks the focus of the Expert Advisory Panel report better articulates the boards' intent.⁶

⁵ Paragraph B14 of the IASB's exposure draft states (this is similar to the wording in paragraph 820-10-35-51F of Topic 820):

If an entity does not have sufficient information to conclude whether a transaction is orderly, it considers the transaction price when measuring fair value or estimating market risk premiums. However, that transaction price may not be determinative of fair value (ie the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When an entity does not have sufficient information to conclude whether particular transactions are orderly, the entity places less weight on those transactions.

⁶ Paragraph 22 of the Expert Advisory Panel Report states:

Even when a market has become inactive, it is not appropriate to conclude that all market activity represents forced transactions. However, ... an entity does not conclude automatically that any transaction price is determinative of fair value. An entity considers all available information, but does not use a transaction price when there is evidence that the transaction was forced. Determining fair value in a market that has become inactive depends on the facts and circumstances and may require the use of significant judgement about whether individual transactions are forced. Any transaction determined to be forced does not form part of a fair value measurement.

Staff paper

Question 1 – Focus of guidance for measuring fair value when markets become less active

Do you agree with the staff recommendation to use the focus in Topic 820, specifically that the guidance pertains to when there has been a significant decline in the volume and level of activity for the asset or liability?

If not, what do you propose and why?

Question 2 – Including the IASB's Expert Advisory Panel report (a)

Do you agree with the staff recommendation to incorporate the concept in paragraph 23(a) from the Expert Advisory Panel report into the fair value measurement standard?

If not, what do you propose and why?

Question 3 – Including the IASB's Expert Advisory Panel report (b)

Do you agree with the staff recommendation to incorporate the concept in paragraph 23(b) from the Expert Advisory Panel report into the fair value measurement standard?

If not, what do you propose and why?