Project **Fair Value Measurement**

Topic **Fair value at initial recognition**

Purpose of this paper

1. This paper addresses the situations in which the fair value of an asset or liability at initial recognition might differ from the transaction price.

2. This paper asks the boards:

    (a) to confirm that the list of situations indicating when a transaction price might differ from fair value is sufficient

    (b) to clarify that the list of situations is not exhaustive

3. Agenda Paper 2F addresses the recognition of gains or losses when an entity's transaction price differs from fair value at initial recognition (day 1 gains or losses).

4. The appendix to this paper compares the proposed guidance for fair value at initial recognition in the IASB's exposure draft *Fair Value Measurement* with the requirements in FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) [1].

5. 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.

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

6. The IASB's exposure draft and Topic 820 list four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price:[2]

   (a) a transaction between related parties;

   (b) a transaction that takes place under duress or the seller is forced to accept the price in the transaction;

   (c) the unit of account represented by the transaction is different from the unit of account for the asset or liability measured at fair value; and

   (d) the market in which the transaction takes place is different from the market in which the entity would sell the asset or transfer the liability.

[1] Topic 820 codified Statement of Financial Accounting Standards No. 157 *Fair Value Measurements*.
[2] Paragraph 36 of the IASB's exposure draft and paragraph 820-10-30-3.

Overview of comments received on the IASB's exposure draft

7. The invitation to comment for the IASB's exposure draft asked interested parties whether the four cases listed in paragraph 6 above are appropriate and sufficient.

8. Most respondents agree with the proposal. That is, they agree that those four cases might lead to a difference between fair value and the transaction price. However, some suggest:

    (a) clarifying whether the list of situations in paragraph 6 is an exhaustive list

    (b) including transactions that take place in a market where there has been a significant decrease in volume and level of activity for the asset or liability (ie markets that are no longer active) in the list of cases that might lead to a difference between fair value and the transaction price.

9. Some respondents are concerned about using fair value at initial recognition. They would prefer to use an entry price.

Staff analysis and recommendation

When the transaction price differs from fair value

10. Some respondents wonder whether the four cases listed in paragraph 6 are examples of *possible* circumstances or the *only* circumstances when a transaction price is not the best indicator of fair value.

11. Many of them prefer the wording in Topic 820 to that proposed in the IASB's exposure draft. They think the IASB's exposure draft contains a presumption that the transaction price *is* the best evidence of fair value, whereas Topic 820 contains a list of situations when the transaction price is *not* the best evidence of fair value.

IASB exposure draft (paragraph 36)	**Topic 820** (paragraph 820-10-30-3)
For example, the transaction price is the best evidence of the fair value of an asset or liability at initial recognition unless:	For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if any of the following conditions exist:

12. The staff will clarify in drafting that the list of situations in paragraph 6 is not exhaustive.

When markets become less active

13. Some respondents think the list in paragraph 6 is incomplete. They suggest adding a fifth case addressing transactions that have taken place in a market where there has been a significant decrease in volume and level of activity for the asset or liability.

14. The staff thinks this is not necessary. The objective of a fair value measurement is to estimate the price at which an orderly transaction would take place between market participants at the measurement date. At initial recognition, the reporting entity has entered into a transaction on the measurement date (ie a transaction took place).

15. Because it is a party to the transaction, the reporting entity knows if the transaction price represents a forced or distress sale (in which case it is covered by the situation in paragraph 6(b)). It also knows if the transaction did not take place at arm’s length (and is covered by the situation in paragraph 6(a)).

16. Transacting in an inactive market does not make a transaction price less valid and does not necessarily require the use of a valuation technique at initial recognition. If an entity thinks the ‘true value’ of an asset is lower than the transaction price, it would not have entered into the transaction. Transactions take place because the buyer of an asset thinks the ‘true value’ is higher than the price paid.

17. The staff thinks that the examples listed in paragraph 6 are sufficient for illustrating when a transaction price might differ from fair value at initial recognition.

Using an entry price notion at initial recognition

18. The IASB exposure draft and Topic 820 define fair value as a current exit price.

19. In developing the proposed definition of fair value, the IASB considered whether a current entry price might be appropriate (rather than a current exit price). The IASB tentatively defined current entry price as:

    > The price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants (including the amount imposed on an entity for incurring a liability) at the measurement date.

20. The tentative definition of current entry price, like fair value, assumes an orderly transaction between market participants at the measurement date. The IASB concluded that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market. As a result, the IASB concluded that it was unnecessary to make a distinction between current exit price and a current exit price in standards with a market-based measurement objective.

21. A current entry price is *not* necessarily the same as the actual price an entity paid to acquire an asset or received to incur a liability. Those who prefer an entry price at initial recognition do not prefer the current entry price as defined above, but the actual transaction price (if there is one). However, the actual transaction price, to the extent that any of the situations in paragraph 6 above exist, might differ from a market-based current entry price.

22. Using the transaction price at initial recognition is outside the scope of this project and is a decision for the boards to make when selecting the measurement basis in other projects.

Question 1 – When the transaction price might differ from fair value
Do the boards agree to clarify that the list of situations in paragraph 6 is not exhaustive? If not, what do you propose and why?

Question 2 – When markets become less active
Do the boards agree with the staff recommendation that the examples listed in paragraph 6 are sufficient for illustrating when a transaction price might differ from fair value at initial recognition? If not, what do you propose and why?

Appendix – Guidance on fair value measurements at initial recognition proposed in the IASB exposure draft and in Topic 820

	Reference	IASB Exposure Draft	Reference	Topic 820
Initial recognition	Paragraph 34	When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (often referred to as an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price).	820-10-30-2	When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price).
Exit price and transaction prices	Paragraph 34	Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them. In some cases, eg in a business combination, there is not a transaction price for each individual asset or liability. Likewise, sometimes there is not an exchange transaction for the asset or liability, eg when biological assets regenerate.	820-10-30-2	Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

Exit and entry prices	Paragraph 35	Although conceptually entry prices and exit prices are different, in many cases an entry price of an asset or liability will equal the exit price (eg when on the transaction date the transaction to buy an asset would take place in the market in which the asset would be sold). In such cases, the fair value of an asset or liability at initial recognition equals the entry (transaction) price.	820-10-30-3	In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition.
When the transaction price might differ from the fair value	Paragraph 36	In determining whether fair value at initial recognition equals the transaction price, an entity shall consider factors specific to the transaction and the asset or liability. For example, the transaction price is the best evidence of the fair value of an asset or liability at initial recognition unless:	820-10-30-3	In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if any of the following conditions exist:
		(a) the transaction is between related parties.		(a) The transaction is between related parties.
		(b) the transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.		(b) The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

		(c) the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that are separately measured or the transaction price includes transaction costs.		(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.
		(d) the market in which the transaction takes place is different from the market in which the entity would sell the asset or transfer the liability, ie the most advantageous market. For example, those markets might be different if the entity is a securities dealer that transacts in different markets with retail customers (retail market) and with other securities dealers (inter-dealer market).		(d) The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal market or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (interdealer market).

Calibrating models	Paragraph 39	Periodically, an entity shall calibrate the valuation technique(s) used to prices from observable current market transactions in the same asset or liability (at initial recognition, this might be the transaction price).	820-10-30-4	If the transaction price represents fair value at initial recognition and a pricing model will be used to measure fair value in subsequent periods, the model shall be calibrated so that the model value at initial recognition equals the transaction price.