Project **Fair Value Measurement**

Topic **Measuring liabilities at fair value**

Purpose of this paper

1. This paper addresses the guidance for measuring the fair value of liabilities. In particular, it:

   (a) describes the transfer notion, including:

      (i) its relationship with a settlement notion, a fulfilment notion and an entry notion (paragraphs 31 – 48)

      (ii) the value of the service (ie the profit margin) and the risk premium (paragraphs 49 – 63)

      (iii) whether the in-use valuation premise applies to liabilities (paragraphs 64 –68)

   (b) addresses whether the fair value of a liability equals the fair value of the counterparty's corresponding asset (paragraphs 70 –85 83).

2. This paper asks the boards to:

   (a) describe the application of a transfer notion when measuring the fair value of a liability (paragraph 69)

   (b) confirm that the fair value of a liability equals the fair value of the counterparty's corresponding asset except in limited circumstances (paragraphs 84 – 85).

3. This paper does **not** address whether any, and if so which, liabilities should be recognised at fair value. Given the objective of a fair value measurement, this paper:

(a) describes what is included in a fair value measurement for liabilities and

(b) provides guidelines for measuring the fair value of a liability given the objective of a fair value measurement.

4. Any concerns about recognising liabilities at fair value will be addressed in a scope assessment, to be discussed at a future meeting.

5. In this paper, the term 'fulfilment amount' means the value (not the cost) of the resources necessary to fulfil an obligation. In a fair value measurement, this is market-based, not specific to the entity holding the obligation. The fulfilment amount is relevant to a transfer notion because the market participant transferee will take into consideration the fact that it will fulfil the obligation when determining an acceptable price to demand for assuming the liability. Furthermore, a fair value measurement does not assume that the reporting entity actually transfers the liability. It is simply a way to arrive at an objective, market based price at a particular measurement date.

6. The fulfilment amount described in this paper is similar to the 'present value of the resources required to fulfil the obligation' in the IASB's exposure draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, this paper is about the fair value measurement of liabilities, not IAS 37. As a result, **we will not discuss the measurement of liabilities in IAS 37 at this meeting.**

7. This paper includes the following appendices:

(a) Appendix A contains a comparison of the proposals in the IASB's exposure draft *Fair Value Measurement* (referred to in this paper the IASB's exposure draft) with the requirements in FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures)

(b) Appendix B contains the examples in Topic 820 that illustrate the application of the transfer notion when there is not an observable transfer price.

8. Agenda Papers 2H and 2I address non-performance risk and restrictions on the transfer of a liability, respectively. We will not talk about them in the context of this paper.

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

9. Both the IASB's exposure draft and Topic 820 address the fair value of liabilities.[1] Appendix A to this paper compares the proposals in the IASB's exposure draft with the requirements in Topic 820.

10. At a high level, the guidance proposed in the IASB's exposure draft and required in Topic 820 is the same. That is, the principle is that the fair value of a liability reflects its transfer between market participants at the measurement date. If there is a quoted price in an active market representing the transfer of the liability (not the corresponding asset), that price must be used. In the absence of a quoted price in an active market, the entity uses another valuation technique. If there is a corresponding asset for the liability, the fair value of the asset represents the fair value of a liability (in all cases in the IASB's exposure draft and in many cases in Topic 820).

11. However, Topic 820 goes further in its guidance (including detailed examples, see Appendix B to this paper) about measuring the fair value of liabilities than does the IASB's exposure draft. Topic 820 states that an entity measures the fair value of a liability using one of the following valuation techniques in the absence of a quoted price in an active market representing the transfer of the liability:

    (a) a valuation technique that uses:

        (i) the quoted price of the identical liability when traded as an asset

        (ii) quoted prices for similar liabilities or similar liabilities when traded as assets

[1] Accounting Standards Update 2009-5 *Measuring Liabilities at Fair Value* amended Topic 820, providing additional guidance on measuring liabilities at fair value.

(b) another valuation technique such as:

(i) an income approach (eg a present value technique) or

(ii) a market approach (eg using the amount that the entity would pay to transfer the identical liability or receive to enter into the identical liability)[2]

12. The IASB's exposure draft takes into account 11(a)(i) and 11(b)(i).

13. 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).[3] 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

14. The invitation to comment for the IASB's exposure draft asked interested parties whether the proposed guidance for measuring the fair value of liabilities is appropriate. In particular, it asked whether:

(a) a fair value measurement should assume that the liability is transferred to a market participant at the measurement date

(b) when there is an active market for transactions between parties that hold a financial instrument as an asset, the observed price in that market (for the asset) represents the fair value of the issuers liability (and when it would not)

[2] Although this refers to 'the entity', the entity must use market participant assumptions when measuring fair value. If the entity were to transfer the liability or incur an identical liability, the transaction would take place with market participants, resulting in a market-based value.
[3] Topic 820 codified SFAS 157.

(c) if there is no corresponding asset for a liability (eg a decommissioning obligation assumed in a business combination), an entity could estimate the price that market participants would demand to assume the liability using present value or other valuation techniques.

15. In August 2009, the FASB significantly expanded the guidance in Topic 820 on measuring the fair value of liabilities by issuing ASU 2009-5. Because the FASB issued ASU 2009-5 after the IASB published the exposure draft, this topic was discussed in the round-table meetings. Participants were asked whether the information in ASU 2009-5 was helpful and could be applied in IFRSs.[4]

The transfer notion

16. Respondents generally agree with the transfer notion in the definition of fair value because it reflects an exit notion and is the logical exit concept for a liability (like an asset, the liability continues (ie it is not extinguished or cancelled) at the measurement date).

17. However, many respondents are concerned about when fair value should be used for liabilities. They think it is appropriate to use a transfer notion for derivative liabilities and liabilities that are traded as assets (although some think the entity must intend to repurchase its traded liability in order to use this amount).

18. Many respondents also are concerned about using a transfer notion because liabilities are rarely transferred. Furthermore, most 'transfers' take place between holders of the asset, not issuers of the liability. A business combination is one of the few examples of the transfer of a liability, although in that case the purchase price is for a bundle of assets and liabilities and so it is difficult to determine what market participants would demand to take on a specific obligation or pay to be relieved of a specific obligation.

---

[4] The IASB held round-table meetings in Norwalk (USA), Tokyo (Japan) and London (United Kingdom). Materials for the round-table meetings are available on the IASB website and to board members upon request.

19. The exposure draft establishes a link between a fulfilment notion and a transfer notion by saying that using a present value technique is based in part on a settlement notion (ie the cash flows incurred to fulfil the obligation) and it produces the same price that would be paid to transfer a liability at the measurement date (see paragraph 28 of the exposure draft). Some respondents think this link is helpful. However, they want to know what is the difference between the fulfilment and transfer notions (eg is the difference solely due to a risk premium or the value of the service provided, and how does one estimate such amounts?). Some also think that using a valuation technique results in a fulfilment amount, not a 'true' transfer price.

20. Some respondents think the definition of fair value should include a 'lower of' concept for liabilities. That is, the fair value of a liability should reflect the lower of the price that would be paid to transfer the liability to a market participant and the price that would be paid to fulfil the obligation with the counterparty.

Does the fair value of the liability equal the fair value of the corresponding asset?

21. Many respondents find the proposal that the fair value of a liability equals the counterparty's corresponding asset to be helpful and practical. However, some respondents think there are situations in which the fair value of the liability will not be equal to the fair value of the corresponding asset. They suggest stating that the observed price for an asset *is likely to* represent the fair value of the issuer's liability (the exposure draft states that the observed price of the corresponding asset *represents* the fair value of the liability).

22. Respondents suggest the following reasons that the fair value of the liability will not equal the fair value of the corresponding asset (each of these is addressed in the staff analysis section below, beginning in paragraph 70):

    (a) for financial assets and liabilities for which there is a bid-ask spread, the exit price for an asset is the bid price, and the exit price for a liability is the ask price. Therefore, a difference between the fair value (exit price) of the liability and the corresponding asset is the bid-ask spread (and for less liquid debt instruments the spread can be wide)

(b) the market in which a liability is issued (the debt origination market) is different from the market in which the corresponding asset is traded (the secondary market)

(c) the market in which the asset is traded is not active

(d) there is a restriction on the sale of the corresponding asset

(e) the unit of account for the asset is different from the unit of account for the liability (eg if the price for the corresponding asset includes a third party credit enhancement).

23. Furthermore, some respondents think that using the fair value of the corresponding asset as the fair value of the liability represents a settlement amount, not a transfer price.

Other comments

24. Some respondents think the valuation premise applies to liabilities as well as to assets. In particular, they think a market participant who assumes the entity's liability should be assumed to have the complementary assets and/or liabilities (eg a business) necessary to fulfil the obligation.

25. They are concerned that without such an assumption, a premium would be needed to compensate the market participant transferee for the fact that it does not have the requisite assets to fulfil the obligation or control over when the obligation will need to be fulfilled (eg for a decommissioning liability or an asset retirement obligation).

Comments from the Fair Value Measurement round-table meetings

26. Participants in the round-table meetings were generally supportive of the guidance in ASU 2009-5. Participants at the US round-table meeting said they find the guidance to be helpful when applying the transfer notion in Topic 820, particularly since observable transfer prices for liabilities rarely exist. They noted that it confirmed practice in that area prior to the publication of the ASU.

27. However, there are some concerns about applying a transfer notion when transfers of liabilities generally do not happen in practice. Some see the ASU as a move away from a 'true' transfer concept to a fulfilment amount or entry notion. In general, the term 'transfer' seems to be problematic (although the terms 'fulfilment' and 'settlement' are equally so).

28. There are also concerns about the assertion that the fair value of a liability equals the fair value of the counterparty's corresponding asset, for the reasons given in the comment letters and listed above.

Staff analysis and recommendation

29. This section addresses:

    (a) applying a transfer notion (paragraphs 31 – 69)

    (b) whether the fair value of a liability can be determined on the basis of the fair value of the counterparty's corresponding asset (paragraphs 70 – 85).

30. The examples in Appendix B illustrate the application of the transfer notion when there is not an observable transfer price.

Applying a transfer notion

31. Most of the controversy about fair value with respect to liabilities is due to the word 'transfer'. Entities do not transfer liabilities (they fulfil them) and in most cases they are legally prohibited from transferring them.

32. Because of this, many prefer the current definition of fair value in IFRSs, which refers to a settlement amount. However, the current definition of fair value is not specific about what a 'settlement amount' means. Does it mean that the liability is extinguished or cancelled at the measurement date? Does the 'settlement' take place with the counterparty? It is not clear how either of these reflects a market-based measurement.

33. In the IASB's exposure draft and Topic 820 the transfer price can be estimated in different ways (both are discussed in detail below):

(a) a transfer between market participants if such an observable price is available

(b) a fulfilment amount or an entry price if no such observable price is available.

34. Conceptually, both (a) and (b) lead to the same fair value measurement, although they have different ways of getting there.

What does 'transfer' mean?

35. A transfer notion reflects a market-based fulfilment amount. That is, it is the present value of the resources a market participant would expect to incur to fulfil the obligation. In accordance with the contract or other terms, the market participant would be required to fulfil the obligation either over time or immediately.

36. Because observable transfers rarely take place, an entity will typically need to estimate the transfer price. This is why the IASB's exposure draft and Topic 820 provide guidance about how to do so.

What is included in a transfer price?

37. To estimate the transfer price, an entity should first look for observable prices for transferring an identical liability to a market participant. If such a price is available, the entity must use it.

38. The observable price for the transfer of a liability is a market-based fulfilment amount. A market-based fulfilment amount can be estimated by using:

(a) the present value of the resources required to fulfil the obligation or

(b) the amount a market participant would receive to enter into an identical liability.

39. That is, the transfer price, fulfilment amount and entry price conceptually all result in the same fair value measurement.

<u>The present value of the resources required to fulfil the obligation</u>

40. The present value of the resources required to fulfil the obligation includes the following:[5]

    (a) the expected outflows of resources a market participant would expect to incur to fulfil the obligation, which include the following:

        (i) the direct costs of fulfilling the obligation (eg payments to the counterparty of the obligation, if there is one, or the labour costs associated with a service obligation)

        (ii) the indirect costs of fulfilling the obligation (eg overhead costs)

        (iii) the value of the service performed on the fulfilment activity (ie the return a market participant would require for undertaking that activity)

    (b) the time value of money

    (c) the risk that the obligation will not be fulfilled (non-performance risk)

    (d) the risk that the actual cash outflows of resources might ultimately differ from those expected (a risk premium).

41. The value of the service and risk premium components are discussed in detail below.

42. Conceptually, the fair value of any liability includes the components in paragraph 40. The value of the service and the risk premium reflect the compensation a market participant would demand for taking on the obligation. This includes the compensation for undertaking the activity and for assuming the risk associated with the obligation (eg the uncertainty about the timing and amount of future cash flows, including the ability to perform the obligation).

43. The compensation a market participant would demand for taking on an obligation might be included in the fair value of a liability in different ways. For example:

---

[5] Appendix C of the IASB's exposure draft and paragraphs 820-10-55-4 – 820-10-55-20 of Topic 820 describe the application of a present value technique.

(a) a financial liability contains a contractual rate of return and a market yield reflecting the compensation for undertaking the activity and for assuming the risk associated with the obligation

(b) a non-financial liability does not contain a contractual rate of return and there is no observable market yield for them. Therefore, the compensation for undertaking the activity and for assuming the risk associated with the obligation must be estimated.

44. Although the starting points for financial liabilities and non-financial liabilities are different, the fair value of both types of liability includes the compensation a market participant would demand for taking on an obligation.

45. Some are concerned about using market-based inputs in the measurement of an entity's liability. For example, an entity might have advantages relative to the market that would make it more beneficial for the entity to fulfil the obligation using its own internal resources, not outsourcing it to a third party contractor. That is a question of whether a liability should be measured at fair value, and not of what fair value is.

46. The objective of a fair value measurement is to provide a market benchmark to use as a basis for assessing an entity's advantages or disadvantages in performance relative to the market. Therefore, when a liability is measured at fair value, the relative efficiency of an entity in fulfilling the obligation using its own resources appears in profit or loss over the course of its settlement, and not before.

<u>The amount a market participant would receive to enter into an identical liability</u>

47. When estimating the amount a market participant would receive to enter into an identical liability, an entity uses inputs that reflect its estimate of the assumptions market participants would consider in determining an acceptable price for the issuance of a liability with the same contractual terms. This takes into account market conditions at the measurement date.

48. This is consistent with measuring the fair value of financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement*. Paragraph AG77 of IAS 39 states that fair value can be measured by comparing the market conditions

that existed at the origination date with current market conditions or interest rates currently charged for similar instruments. If conditions have changed since the most recent market transaction (eg since issuance or origination), the corresponding change in fair value of the financial instrument is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate for any differences from the instrument being valued.

What is the value of the service?

49. When estimating the expected cash outflows of resources required to fulfil the obligation, a market participant would demand compensation for the use of the resources necessary to fulfil the obligation. For a financial liability, this will be included in the credit spread, as discussed above. For a non-financial liability, this will need to be estimated as the value of the service. To the extent there is information available, an entity might use the amounts a third-party contractor would charge to undertake the entire activity on the entity's behalf.

50. The value of the service:

    (a) represents compensation for tying up resources that could be used otherwise (an opportunity cost) and for the skills used in the activity

    (b) results in a measurement that represents the *value* of fulfilling the obligation, rather than the *cost* of fulfilling the obligation. In other words, a measurement that includes the value of the service represents the price at which a transaction would take place between market participants, thereby meeting the objective of a fair value measurement.

51. If an entity uses the amounts a third-party contractor would charge, the market-based profit margin is already included in that amount and no further adjustment is necessary. If that information is not available, an entity must estimate the value of the service by considering the compensation market participants would require.

52. Agenda Paper 2B describes the use of market participant assumptions in a fair value measurement. In many cases, an entity will start with its own data and make adjustments for information that indicates that market participants would

make different assumptions. In this case, an entity might begin by considering the compensation it would require to perform this activity for a third party.

What is the risk premium?

53. Appendix C of the IASB's exposure draft and paragraphs 820-10-55-4 – 820-10-55-20 of Topic 820 describe the application of a risk premium in a fair value measurement using a present value technique.

54. A present value calculation uses cash flows that are estimates rather than known amounts. In many cases, both the timing and the amount of the cash flows will be uncertain. Even contractually fixed amounts, such as the payments on a loan, will be uncertain if there is a risk of default or delinquent repayments (Agenda Paper 2H addresses the risk of non-performance; it is not discussed further in this paper).

55. Market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of a liability. As a result, a fair value measurement includes a risk premium that reflects the amount market participants would demand for bearing the risk (uncertainty) in the cash flows.

56. An entity can approach risk adjustments in one of the following ways:

    (a) Using the discount rate adjustment technique that discounts the most likely cash flows at a rate that includes an adjustment for the risk inherent in those cash flows

    (b) Using an expected present value technique that discounts the expected cash flows at a rate appropriate for the risk inherent in those cash flows[6]

    (c) Using a present value technique that discounts the expected cash flows at the risk-free rate (or a credit-adjusted risk-free rate) and then adding a risk premium to the resulting present value.

[6] In Method 1 of the expected present value technique, the expected cash flows are adjusted to take into account systematic risk (to arrive at certainty-equivalent cash flows) and discounted at the risk-free rate. In Method 2, the expected cash flows are not adjusted, and are discounted at a rate that takes into account systematic risk (eg using the Capital Asset Pricing Model). See paragraph 59(a) below for a discussion of systematic and diversifiable risk.

57. Regardless of the technique used, an entity needs to ensure that it is not double-counting or omitting risk for which market participants would expect to be compensated.

58. Some have concerns about when a risk premium should be included in the measurement of a liability and how it should be calculated.

59. The risk premium:

    (a) adjusts the measurement for the systematic risk inherent in the liability, not the diversifiable risk. This is because market participants expect to be compensated for systematic risk. They do not expect to be compensated for risk that can be avoided by holding a diversified portfolio.

    (b) does not consider the benefit an entity might have from not being exposed to risk because it has relieved itself of the obligation. This is because the obligation will be fulfilled and this would be reflected in the price.

60. Estimating an appropriate risk premium can be difficult, particularly because there is no market information available to help quantify risk premiums for non-financial liabilities. However, the degree of difficulty of doing so is not a sufficient reason to exclude it from a fair value measurement.

61. Although there have been many empirical studies attempting to quantify the market risk premium for equity instruments (comparing actual security returns with the risk-free rate over a historical period) and the market risk premium for a debt instrument can be inferred from the difference between the current yield (net of expected defaults) on the instrument and the risk-free rate (ie the credit spread), there is no market information available to help quantify risk premiums for non-financial liabilities.

62. This is because:

    (a) there are no observable prices available for non-financial liabilities

(b) each non-financial liability is different and it would generally be inappropriate to apply the return on a particular liability to another (different) liability.

63. As a result, it would be difficult to describe in a converged fair value measurement standard how a risk premium should be calculated. However, the standard can explain what it represents and give general guidance about its measurement.

Does the valuation premise apply to liabilities?

64. As noted above, some respondents think a market participant who assumes the entity's liability should be assumed to have the complementary assets and/or liabilities (eg a business) necessary to fulfil the obligation. That is, they think the fair value of a liability should assume the in-use valuation premise.

65. The intent behind the valuation premise 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.

66. 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. In other words, the machine has a different fair value depending on whether one assumes that the asset is being used with other assets or on its own.

67. Unlike an asset, a liability does not have a different fair value whether it is used with other assets and liabilities because liabilities do not 'derive value from' other assets or liabilities. Rather, liabilities depend on the existence of an asset (eg a financial liability depends on the existence of the assets to repay the obligation, and a non-financial liability depends on the existence of assets to perform or otherwise fulfil the obligation). One cannot assume that a liability exists without access to the assets necessary to fulfil the obligation.

68. The staff thinks this is already 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 (otherwise it would not have the motivation to transact for the liability).

Staff recommendation

69. The staff recommends:

(a) requiring an entity to measure the fair value of a liability, in the absence of a quoted price in an active market representing the transfer of a liability, as follows:

(i) using the quoted price of the identical liability when traded as an asset (ie a Level 1 measurement), if that price is available

(ii) if that price is not available, using quoted prices for similar liabilities or similar liabilities when traded as assets (ie a Level 2 measurement)

(iii) if observable inputs are not available, using another valuation technique such as:

(1) an income approach (eg a present value technique) or

(2) a market approach (eg using the amount that a market participant would pay to transfer the identical liability or receive to enter into the identical liability)

(b) describing the compensation a market participant would demand for taking on an obligation in the application of a present value technique

(c) clarifying that the transfer of a liability assumes that a market participant transferee has the knowledge and ability to fulfil the obligation.

Questions for the boards
Do you agree with the staff recommendations in paragraph 69?

If not, what do you propose and why?

Whether the fair value of a liability can be determined on the basis of the fair value of the counterparty's corresponding asset

70. Both the IASB's exposure draft and Topic 820 state that the fair value of a liability can be determined by reference to the fair value of the counterparty's corresponding asset. The IASB's exposure draft states that in the absence of a quoted price for the liability when traded as an asset, the entity uses the same methodology that the counterparty would use to measure the fair value of the corresponding asset. Topic 820 only explicitly addresses liabilities traded as assets *for which there are quoted prices*.

71. This raises the following questions:

    (a) Are there situations in which the fair value of the liability would not equal the fair value of the counterparty's corresponding asset?

    (b) Is it necessary that there is a quoted price for the asset? If not, should fair value be determined based on the methodology that the counterparty would use, or that market participants would use?

    (c) If an entity uses the quoted price for the corresponding asset, what is the resulting level of the fair value hierarchy?

When might the fair value of the liability not equal the fair value of the corresponding asset?

72. The staff thinks that in most cases the fair value of the liability will be equal to the fair value of the corresponding asset. However, there might be situations in which there could be a difference and Topic 820 provides examples of some of them (see paragraph 76 below). For a financial liability, the most likely reason for a difference is the bid-ask spread. If an issuer repurchases its debt obligation, it is likely to do so at the ask price for the asset.[7] The holder of the asset is likely to measure fair value at the bid price. The staff thinks this is covered by the bid-ask spread guidance in Topic 820 and proposed in the IASB's exposure draft.

[7] This assumes that the issuer can legally repurchase its debt. This paper ignores legal restrictions on repurchase and price changes due to repurchases (including blockage factors, which the boards will discuss at a future meeting).

That is, the price within the bid-ask spread that is most representative of fair value in the circumstances will be used to measure fair value.

73. The staff thinks the following situations will **not** result in a difference in fair values:

    (a) the market in which the asset is traded is not active. A lack of liquidity in the market results from there being few, if any, market participants willing to buy the asset. If the issuer wants to repurchase its debt, it becomes a willing buyer and could repurchase its debt at the price of the asset.

    (b) there is a restriction on the sale of the corresponding asset. Topic 820 states that in determining the fair value of a liability, an entity does not adjust the quoted price of the corresponding asset for the effect of a restriction preventing the asset's sale that is already reflected in that price. This is because the effect of a restriction would be considered in the pricing of the liability at issuance.

74. The staff thinks the point in paragraph 22(b) about the origination market for the liability being different from the secondary market for the asset is an initial recognition issue. Initial recognition and day 1 gains or losses are addressed in Agenda Papers 2E and 2F.

75. The staff thinks the observed price for the corresponding asset is presumed to represent the fair value of the issuer's liability. Determining that the observed price for the corresponding asset does not represent the fair value of the liability requires judgement. Because the objective is to arrive at a fair value for the identical liability, it is important first to understand the characteristics of the liability being measured at fair value, and then to assess the characteristics of the corresponding asset to determine whether the fair value of the corresponding asset represents the fair value of the liability.

76. Paragraph 820-10-35-16D of Topic 820 states that the fair value of a liability when traded as an asset shall be adjusted for factors specific to the asset that are not applicable to the fair value of the liability. The circumstances in which the fair value of the asset might need to be adjusted are:

(a) the quoted price for the asset relates to a similar (but not identical) liability traded as an asset [this situation is not explicitly addressed in the IASB's exposure draft]

(b) the unit of account for the asset is not the same as for the liability (eg if the quoted price for the asset reflects a third party credit enhancement) [this situation is explicitly addressed in the IASB's exposure draft].

Does there need to be a quoted price for the corresponding asset?

77. Topic 820 refers to quoted prices for liabilities traded as assets. The IASB's exposure draft states that an entity should measure fair value using the methodology that the counterparty would use.

78. The staff thinks it is not necessary that a liability be traded as an asset on an exchange. Most liabilities are not traded as assets on an exchange. However, that does not mean that their value cannot be measured. The IASB's exposure draft and Topic 820 provide guidance about how to do this.

79. Although the IASB proposed specifying using the methodology the *counterparty* would use to measure the fair value of the corresponding asset, the staff thinks entities should use the methodology *market participants* would use. This is because the objective of a fair value measurement is to arrive at a market price. Although the staff believes both would result in the same estimate, we think it will be clearer to specify a market participant view.

80. By virtue of transacting in a public market, the counterparty is only able to buy at a price at which another market participant will sell, and is only able to sell at a price at which another market participant will buy. In other words, the counterparty transacts in the context of the market environment. As a result, a quoted price (and a fair value measurement) reflects market participant expectations, which might be different from the particular counterparty's expectations.

Application of the fair value hierarchy

81. A Level 1 fair value measurement for the liability is a quoted price in an active market for the identical liability at the measurement date.

82. Topic 820 states that a quoted price for the identical liability when traded as an asset in an active market is also a Level 1 fair value measurement when no adjustments to that quoted price are required.

83. However, as required in Topic 820 and proposed in the IASB's exposure draft, it is necessary to determine whether the quoted price for the identical liability when traded as an asset in an active market should be adjusted for factors specific to the liability and the asset. Any adjustment to the quoted price of the asset will result in the measurement being categorised within a lower level of the fair value hierarchy.

Staff recommendation

84. The staff recommends:

    (a) requiring entities to:

        (i) determine whether the fair value of a liability when traded as an asset represents the fair value of the liability and

        (ii) make adjustments to the fair value of the corresponding asset to the extent that the fair value of the asset does not represent the fair value of the liability.

    (b) requiring entities to use the fair value of a corresponding asset even when that asset is not traded on an exchange

    (c) requiring entities to measure the fair value of the corresponding asset using the methodology *market participants* would use

    (d) stating that a quoted price for a corresponding asset in an active market is also a Level 1 fair value measurement for the liability when no adjustments to that quoted price are required.

85. The staff thinks it is not necessary to include bid-ask spreads in the list in paragraph 76 because:

    (a) it is not a 'circumstance'

    (b) not all entities transact at the bid price for assets or the ask price for liabilities

(c) any adjustment to reflect bid-ask spreads is covered by the section on bid-ask spreads in the fair value measurement standard.[8]

Questions for the boards
Do you agree with the staff recommendations in paragraphs 84 and 85? If not, what do you propose and why?

[8] That is, the price within the bid-ask spread that is most representative of fair value in the circumstances will be used to measure fair value.

Appendix A – Measuring the fair value of liabilities using the IASB's exposure draft and Topic 820

Issue	**Reference**	**Proposal in the IASB's exposure draft**	**Reference**	**Requirement in Topic 820**
Transfer notion	Paragraph 25	A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability continues and the market participant transferee would be required to fulfil it; it is not settled with the counterparty or otherwise extinguished).	820-10-35-16	A fair value measurement assumes both of the following: a. The liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled). …
Use of corresponding asset	Paragraph 26 Paragraph 27	In many cases, there will not be an observable market price for the transfer of a liability. In such cases, an entity shall measure the fair value of a liability using the same methodology that the counterparty would use to measure the fair value of the corresponding asset. If there is an active market for transactions between parties who hold debt securities as an asset, the observed price in that market also represents the fair value of the issuer's liability.	820-10-35-16A 820-10-35-16D	A fair value measurement assumes that a liability is exchanged in an orderly transaction between market participants. However, liabilities are rarely transferred in the marketplace because of contractual or other legal restrictions preventing the transfer of liabilities. Some liabilities (for example, debt obligations), however, are traded in the marketplace as assets. When measuring the fair value of a liability using the quoted price of the liability when traded as an asset, the reporting entity shall not adjust the quoted price of the asset for the effect of a restriction preventing its sale.

Issue	Reference	Proposal in the IASB's exposure draft	Reference	Requirement in Topic 820
				However, the quoted price of the liability when traded as an asset shall be adjusted for factors specific to the asset that are not applicable to the fair value measurement of the liability. Some circumstances in which a reporting entity shall consider whether the quoted price of the asset should be adjusted include the following: a. The quoted price for the asset relates to a similar (but not identical) liability traded as an asset. b. The unit of account for the asset is not the same as for the liability (for example, the quoted price for the asset includes the effect of a third-party credit enhancement). See paragraph 820-10-35-18A for further guidance.
Third party credit enhancements	Paragraph 27	An entity shall adjust the observed price for the asset for features that are present in the asset but not present in the liability, or vice versa. For example, in some cases the observed price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a	820-10-05-3	Liabilities are often issued with credit enhancements obtained from a third party. For example, debt may be issued with a financial guarantee from a third party that guarantees the issuer's payment obligations. In this example, if the issuer of the liability fails to meet its payment

Issue	Reference	Proposal in the IASB's exposure draft	Reference	Requirement in Topic 820
		third-party credit enhancement. In such cases, the objective is to estimate the fair value of the issuer's liability, not the price of the combined package. Thus, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement, a feature that is not present in the liability.		obligations to the investor, the guarantor becomes obligated to make the payments on the issuer's behalf and the issuer becomes obligated to the guarantor. That guarantee is generally purchased by the issuer who then combines it with, for example, debt and then issues the combined security to an investor. By issuing debt combined with the guarantee, the issuer is able to more easily market its debt and either reduce the interest rate paid to the investor or receive higher proceeds at issuance.
			820-10-25-2	The proceeds received by the issuer from the investor for a liability having the characteristics set forth in the preceding paragraph represent consideration for, and shall be allocated to, both the issued liability and the premium for the credit enhancement purchased on the investor's behalf.
			820-10-35-18A	The issuer of a liability with the characteristics set forth in paragraph 820-10-25-1 shall not include the effect of the credit enhancement in the fair value measurement of the liability. For

Issue	Reference	Proposal in the IASB's exposure draft	Reference	Requirement in Topic 820
				the issuer, the unit of accounting for a liability measured or disclosed at fair value does not include the third-party credit enhancement. This paragraph does not apply to the holder of the issuer's credit-enhanced liability.
Use of valuation technique	Paragraph 28	If there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity shall estimate the price that market participants would demand to assume the liability using present value techniques (see Appendix C) or other valuation techniques (see paragraphs 38–40). When using a present value technique, an entity must, among other things, estimate the future cash outflows that market participants would incur in fulfilling the obligation. An entity may estimate those future cash outflows by: (a) estimating the cash flows the entity would incur in fulfilling the obligation; (b) excluding cash flows, if any, that other market participants would not incur; and	820-10-35-16B	If a quoted price in an active market for the identical liability is available, it represents a Level 1 measurement. In circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity shall measure fair value using one or more of the following techniques: a. A valuation technique that uses: 1. The quoted price of the identical liability when traded as an asset 2. Quoted prices for similar liabilities or similar liabilities when traded as assets. b. Another valuation technique that is consistent with the principles of this Topic. Two examples would be an income approach, such as a present value technique, or a market approach, such as a

Issue	Reference	Proposal in the IASB's exposure draft	Reference	Requirement in Topic 820
		(c) including cash flows, if any, that other market participants would incur but the entity would not incur.		technique that is based on the amount at the measurement date that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability.
Relationship with a settlement notion or entry price	Paragraph 28	Although the technique is based, in part, on a settlement notion (ie cash flows incurred to fulfil the obligation), it produces the same price that would be paid to transfer a liability at the measurement date, provided that technique is applied in a manner consistent with Appendix C. This is because a market participant transferee would assume the same obligation to fulfil the liability. An entity need not undertake exhaustive efforts to determine the cash flows in (b) and (c) above. However, an entity shall not ignore information about market participant assumptions that is reasonably available.	820-10-35-16G	When measuring the fair value of a liability using a valuation technique, a reporting entity shall ensure that the fair value measurement is consistent with the principles of this Topic, that is, the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. For example, when using a technique based on the amount at the measurement date that the reporting entity would receive to enter into the identical liability (see paragraph 820-10-35-16B), the inputs shall reflect the assumptions that market participants would use (or the reporting entity's own assumption about the assumptions that market participants would use) in the principal or most advantageous market for issuance of a liability with the same contractual terms.

Appendix B – Liabilities examples in Topic 820

Example 9: Measuring Liabilities

The following Cases illustrate the measurement of liabilities:

a. Asset Retirement Obligation (Case A)

b. Debt Obligation: Quoted Price (Case B)

c. Debt Obligation: Present Value Technique (Case C).

Case A: Asset Retirement Obligation

820-10-55-66

On January 1, 20X1, Entity A completes construction of and places into service an offshore oil platform. The entity is legally required to dismantle and remove the platform at the end of its useful life, which is estimated to be 10 years. According to the guidance in paragraph 410-20-25-4, the entity is required to recognize, at fair value, an asset retirement obligation.

820-10-55-67

On the basis of the guidance in paragraph 410-20-30-1, Entity A uses the expected present value technique to measure the fair value of the asset retirement obligation.

820-10-55-68

If Entity A was contractually allowed to transfer its asset retirement obligation to a market participant, Entity A believes a market participant would use all of the following inputs, probability-weighted as appropriate, in determining the price it would expect to receive:

a. Labor costs

b. Allocation of overhead costs

c. Profit on labor and overhead costs

d. Effect of inflation on estimated costs and profits

e. Risk premium for bearing the uncertainty inherent in cash flows, other than inflation

f. Time value of money, represented by the risk-free rate

g. Nonperformance risk relating to the liability, including Entity A's own credit risk.

820-10-55-69

The significant assumptions used in Entity A's estimate of fair value are as follows:

a. Labor costs are based on current marketplace wages required to hire contractors to dismantle and remove offshore oil platforms. Entity A assigns probability assessments to a range of cash flow estimates as follows.

Cash Flow Estimate	Probability Assessment	Expected Cash Flows
$ 100,000	25%	$ 25,000
$ 125,000	50%	62,500
$ 175,000	25%	43,750
		$ 131,250

The probability assessments are based on Entity A's experience with fulfilling obligations of this type and its knowledge of the market.

b. Entity A estimates allocated overhead and equipment operating costs using the rate it applies to labor costs (80 percent of expected labor costs). This is consistent with the cost structure of market participants.

c. A contractor typically adds a markup on labor and allocated internal costs to provide a profit margin on the job. The profit margin used (20 percent) represents Entity A's understanding of the operating profit that contractors in the industry generally earn to dismantle and remove offshore oil platforms. Entity A believes this rate is consistent with the rate a market participant would demand as a return for bearing the obligation.

d. Entity A assumes a rate of inflation of 4 percent over the 10-year period on the basis of available market data.

e. A contractor would typically demand and receive a premium (market risk premium) for bearing the uncertainty inherent in locking in today's price for a project that will not occur for 10 years. Entity A estimates the amount of that premium to be 5 percent of the expected cash flows, adjusted for inflation.

f. The risk-free rate of interest for a 10-year maturity on January 1, 20X1, is 5 percent. Entity A adjusts that rate by 3.5 percent to reflect its risk of nonperformance. Therefore, the discount rate used to compute the present value of the cash flows is 8.5 percent.

820-10-55-70

Entity A believes that its assumptions would be used by market participants. In addition, Entity A does not adjust its fair value measurement for the existence of a restriction preventing it from transferring the liability. As illustrated in the following table, Entity A estimates the fair value of its liability for the asset retirement obligation to be $194,879.

	Expected Cash Flows 1/1/X1
Expected labor costs	$ 131,250
Allocated overhead and equipment costs (.80 x $131,250)	$ 105,000
Contractor's profit markup [.20 x ($131,250 + $105,000)]	$ 47,250
Expected cash flows before inflation adjustment	$ 283,500
Inflation factor (4% for 10 years)	1.4802
Expected cash flows adjusted for inflation	$ 419,637
Market-risk premium (.05 x $419,637)	$ 20,982
Expected cash flows adjusted for market risk	$ 440,619
Expected present value using discount rate of 8.5% for 10 years	$ 194,879

Case B: Debt Obligation: Quoted Price

820-10-55-71

On January 1, 20X1, Entity B issues at par a $2 million BBB-rated exchange-traded 5-year fixed-rate debt instrument with an annual 10 percent interest coupon. Entity B has elected to account for this instrument under the fair value option.

820-10-55-72

On December 31, 20X1, the instrument is trading as an asset in an active market at $929 per $1,000 of par value after payment of accrued interest. Entity B uses the quoted price for the asset in an active market as its initial input into the fair value measurement of its liability ($929 × [$2 million ÷ $1,000] = $1,858,000). In determining whether the quoted price for the asset in an active market represents the fair value of the liability, Entity B evaluates whether the quoted price for the asset includes the effect of factors not applicable to the fair value measurement of a liability, for example, whether the quoted price for the asset includes the effect of third-party credit enhancements. Entity B determines that no adjustments are required to the quoted price of the asset. Accordingly, Entity B concludes that the fair value of its debt instrument at December 31, 20X1, is $1,858,000. Entity B categorizes and discloses the fair value measurement of its debt instrument as a Level 1 measurement.

Case C: Debt Obligation: Present Value Technique

820-10-55-73

On January 1, 20X1, Entity C issues at par in a private placement a $2 million BBB-rated 5-year fixed-rate debt instrument with an annual 10 percent interest coupon. Entity C has elected to account for this instrument under the fair value option.

820-10-55-74

At December 31, 20X1, Entity C still carries a BBB credit rating. Market conditions, including available interest rates, credit spreads for a BBB-quality credit rating and liquidity, remain unchanged from the issuance date of the debt instrument. However, Entity C's credit spread has deteriorated by 50 basis points due to a change in its risk of nonperformance. After considering all market conditions, Entity C concludes that if it was to issue the instrument at the measurement date, the instrument would bear a rate of interest of 10.5 percent or Entity C would receive less than par in proceeds from the issuance of the instrument.

820-10-55-75

For the purpose of this example, the fair value of Entity C's liability is calculated using a present value technique. Entity C believes a market participant would use all of the following inputs (consistent with paragraph 820-10-55-5) in determining the price the market participant would expect to receive to assume Entity C's obligation:

a. Terms of the debt instrument, including all of the following:

    1. Coupon interest rate of 10 percent

    2. Principal amount of $2 million

    3. Term of 4 years.

b. Change in risk of nonperformance from the date of issuance of 50 basis points.

820-10-55-76

On the basis of its present value technique, Entity C concludes that the fair value of its liability at December 31, 20X1, is $1,968,641. Entity C does not include any additional input into its present value technique for risk or profit that a market participant might require for compensation for assuming the liability. Because Entity C's obligation is a financial liability, Entity C believes the interest rate already captures the risk or profit that a market participant would require for compensation for assuming the liability. Furthermore, Entity C does not adjust its present value technique for the existence of a restriction preventing it from transferring the liability.