Project **Fair Value Measurement**

Topic **Plan for publishing educational material to accompany an IFRS on fair value measurement**

Purpose of this paper

1. This paper discusses the staff's plans for developing educational material for measuring the fair value of difficult to value assets and liabilities. That is, assets and liabilities for which Level 1 and Level 2 inputs are not available. These plans are a result of the concerns raised by entities in emerging and transition economies about applying fair value measurement principles in their jurisdictions.

2. To reinforce the IASC Foundation's goal of promoting the adoption and consistent application of a single set of high quality international accounting standards and in taking into account of the needs of entities in emerging and transition economies, the IASC Foundation publishes some educational material that is leveraged from the standard-setting process.

3. Educational material on fair value measurement would be useful to entities applying IFRSs because (a) many questions have been raised about how to apply fair value measurement principles, particularly in emerging and transition economies, and (b) fair value is used in many IFRSs and knowledge about its application is necessary for applying IFRSs generally.

4. Such educational material would be published under the IASC Foundation Education brand and would be prepared by the IASC Foundation education staff, in conjunction with the fair value measurement project team. The

educational material would not be part of the forthcoming IFRS on fair value measurement and would not be approved by the IASB.

5. Because this project will result in the publication of a converged fair value measurement standard, any educational material developed for applying the forthcoming IFRS on fair value measurement might also be used by entities applying US GAAP (eg FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures)[1]). Therefore, this paper is equally relevant to the FASB. The FASB staff would monitor the development of any educational material about fair value measurement.

Background

6. Entities in emerging and transition economies have consistently expressed to the IASB their concerns about applying fair value measurement principles in their jurisdictions. These entities are concerned that:

   (a) the proposed fair value measurement guidance is not detailed enough to allow them to develop estimates of fair value on a consistent basis

   (b) there is limited availability of practitioners in their jurisdictions who have the skills to apply the guidance (and as a result entities often are unfamiliar with applying the necessary judgements)

   (c) there is limited access to market data to develop fair value measurements because there are few deep and active markets, there are often few willing buyers and sellers and prices often fluctuate considerably

   (d) developing estimates of fair value (and preparing the resulting disclosures) will be expensive.

7. These concerns are not specific to entities in emerging and transition economies. Entities in *developed economies* also needed guidance during the credit crisis.

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

Entities in *developed economies* have also asked the IASB for guidance about measuring the fair value of unquoted equity instruments given the requirement that they be recognised at fair value in IFRS 9 *Financial Instruments*.[2]

8. Any educational material to be developed must benefit all entities equally. That is, they cannot benefit entities in emerging and transition economies without being made available to entities in developed economies. Furthermore, there cannot be a different threshold for measuring fair value depending on jurisdiction. Only by performing fair value measurements will entities learn how to do them appropriately and robustly.

9. As a result, this paper focuses on the need for educational material for measuring the fair value of assets and liabilities for which there are not Level 1 or Level 2 inputs—*regardless of jurisdiction*.

Outreach activities to-date

10. The IASB has solicited feedback about the practical application of fair value measurement principles in emerging and transition economies through:

    (a) the fair value measurement round-table meetings in autumn 2009 and other outreach activities and

    (b) a request for input posted on the IASB's fair value measurement project web page and emailed to eIFRS subscribers.

11. The feedback received is summarised in paragraphs 18-25.

Round-table meetings and other outreach activities

12. The IASB asked participants at the fair value measurement round-table meeting in Tokyo to discuss (a) whether the proposed fair value measurement principles are practical for entities in emerging and transition economies and (b) whether additional guidance (eg in the form of educational material) is needed.

[2] At their February joint meeting, the boards tentatively decided not to provide additional guidance in a converged fair value measurement standard about measuring the fair value of difficult to value assets and liabilities (including unquoted equity instruments).

13. In addition, over the past several months the project team has had informal meetings in China, India, Malaysia and Singapore. We also have sought input from IASB members from emerging and transition economies, Standards Advisory Council (SAC) members and national standard setters.

Request for input

14. The IASB asked for input on the practical application of fair value measurement principles in emerging and transition economies. The request for input was posted on the IASB's fair value measurement project page in December 2009, with a request that comments be received by 31 January 2010. Interested parties were asked to provide the following input:

    (a) any issues that might require additional clarification in the final IFRS on fair value measurements

    (b) examples or case studies of transactions or situations specific to their jurisdiction that would make the fair value measurement guidance as proposed in the exposure draft unpractical.

15. The IASB received 33 responses from the following countries:[3]

Country	Responses
Argentina	1
Brazil	1
Chile	1
China	1
Germany	1
Hong Kong	2
India	6
Japan	2
Korea	1
Madagascar	1
Malaysia	1
Malta	1
Mexico	1
Pakistan	1

[3] Some of the respondents represented entities or industries in other countries. For example, one of the responses from the United States described application issues for entities in Malawi, Nicaragua, Ireland and the United States.

Country	Responses
Romania	1
Russia	1
South Africa	1
United Kingdom	4
United States	3
Venezuela	1
Not disclosed	1
Total	**33**

16. Because it was an informal request by the IASB staff, the responses are being treated as confidential.

Overview of feedback received

17. Most entities in emerging and transition economies ask the IASB to provide more guidance about applying the proposals in the exposure draft. They think the proposals, like Topic 820, were written with entities in developed economies in mind. One of the biggest concerns is with consistency in application and comparability across entities.

18. The feedback received through the various outreach activities described above is categorised as follows:

    (a) the use of fair value in IFRSs (paragraphs 19-22)

    (b) structural issues in some jurisdictions (paragraphs 23-24)

    (c) other feedback received (paragraph 25)

The use of fair value in IFRSs

19. Many we have talked to and who responded to the request for input have concerns about using fair value as a measurement basis when there is not a quoted price for an identical asset in an active market.[4] They think fair value

[4] Very little has been raised about the measurement of liabilities, and when there is, it is from the perspective of the asset holder, not the liability issuer. The staff thinks this does not mean that the fair value measurement of liabilities is not an issue, but that most people think about fair value in the context of assets.

assumes a mature and efficient market in which unrelated parties are able to transact of their own free will, and are concerned that such an assumption does not hold in many emerging and transition economies.

20. In addition, many are uncomfortable with using Level 3 inputs because they think the resulting fair value measurement is subjective and unreliable. Some have the perception that entities cannot measure fair value using unobservable inputs given the priority placed on observable data.

21. Some would prefer to use historical cost or an entity-specific measurement instead.

22. These concerns are not specific to entities in emerging and transition economies and have been raised by entities in developed economies throughout the fair value measurement project, including in their comment letters to the IASB's exposure draft *Fair Value Measurement*. Whether to use fair value as a measurement basis in a particular circumstance is outside the scope of the fair value measurement project and would not form part of any educational material developed for the forthcoming IFRS on fair value measurement.

Structural issues

23. Many of the concerns raised by entities emerging and transition economies relate to the structural issues that make the valuation process different from that in developed economies. Structural issues affect whether a transaction is orderly, whether it is between independent (unrelated) parties and whether a contract has legal status (is enforceable or not). Structural issues include, for example:

    (a) legal environment: in emerging and transition economies, the legal environment might be very different from that in developed economies. For example:

        (i) contracts might not be legally binding, court decisions might not be enforced and bribery might be common practice.

(ii) in some cases, laws might change without warning, making a highest and best use assessment difficult.

(iii) it might be difficult to identify the appropriate ‘market participants’ when transaction terms differ depending on who the counterparties to the transaction are (eg local versus foreign entities, well-connected parties versus others).

(iv) investors might not always have a legal right to information about their investments, or a legal right on a timely basis (eg investees might have the right to withhold information from investors).

(b) market issues: in emerging and transition economies, markets do not always function in the same manner as markets in developed economies. For example:

(i) observable ‘market data’ might not be available to some entities.

(ii) observable market data might not be available for the duration of the asset or liability being measured. For example, interest rates might only be quoted for up to 5 years in the future or foreign exchange rates might not be available for the duration of a contract

(iii) published interest rates might be based on government stipulated rates, which do not necessarily reflect the borrowing entity’s credit risk or the price of credit.

(iv) a few market participants might be able to dictate interest rates and other economic data.

(v) a few market participants might be able to move the market, resulting in increased and unexplained volatility in asset prices.

(vi) market prices are more easily influenced (eg related parties are able to buy or sell to influence the market price in their favour).

(vii) limited information about transactions is available to the public.

(viii) the government might require entities to sell or buy assets to avoid widespread financial disruption.

(ix) some entities (eg foreign entities) are prohibited from entering a market (either all markets within a particular country or a specific market in that country). Such restrictions on capital flows limit the arbitrage opportunities, which are an essential characteristic of efficient markets.

(x) the government might institute price controls.

(xi) the government might provide guarantees and subsidies for specific industries.

(xii) there are frequent freezes in market trading.

(xiii) there are limited historical data available, mainly because prices and other economic data have only recently been monitored and recorded (eg there might be only a few years of historic pricing data from which to calculate an expected market risk premium for applying the capital asset pricing model).

(c) audit issues: auditors might need training about valuation and how to question management's judgement when valuations are performed using unobservable inputs.

(d) regulatory environment: regulators might scrutinise the difference between the carrying amount of an asset at fair value and the ultimate transaction price upon disposal of the asset and conclude that the fair value measurement was 'wrong'.

(e) lack of valuation expertise: it might be difficult to find valuers who are independent, experienced, competent and who have an understanding of the local market.

(f) cost: the cost of measuring fair value is likely to be higher in emerging and transition economies than it is in developed economies because there are few observable inputs, so entities must perform valuations using unobservable inputs (and prepare the necessary disclosures for Level 3 fair value measurements). This means that entities must take the time necessary to find inputs and conclude that a fair value measurement is reasonable in the circumstances. If the entity does not have the expertise in-house, it must hire an external valuer. In addition, the audit of fair value measurements that use unobservable inputs will be more costly. Some suggest providing guidelines for striking a balance between providing meaningful information and the limited resources (including time) in which to do it.

(g) other structural issues:

(i) information is not always available in a timely manner.

(ii) some jurisdictions require the use of observable market data, and fair value cannot be measured by appraisal.

24. Through the feedback received, it is evident that not all emerging and transition economies face the same structural issues (eg some do not have government intervention) and they do not have the same challenges. The structural issues raised are not something the IASB can resolve (and are not all specific to fair value measurement, but relate to applying IFRSs generally), but they might influence the Board's decision about the effective date of an IFRS on fair value measurement.

Other feedback

25. Some have provided the following feedback:

(a) the guidance in IFRS 9 about when cost might represent fair value is helpful, although some find it to be too restrictive.

(b) audit standard setters should be involved in any educational efforts undertaken by the IASB. For example, auditors need to determine how extensive the support documentation must be to be sufficient when there are no quoted prices or other observable inputs.

(c) the proposed disclosure requirements might provide commercially sensitive information to competitors.

(d) the wording of the exposure draft is difficult to understand.

Plan for developing educational material about measuring fair value

26. This section discusses the staff's plans for developing educational material to help entities apply the principles in the forthcoming fair value measurement standard.

27. We do not envisage creating a 'how to' manual for performing valuations. Rather, the educational material would describe the thought process for and what to consider when measuring fair value. In summary, it would facilitate the knowledge transfer between developed and developing economies.

Presumptions underlying a fair value measurement standard

28. To-date, nothing we have heard indicates that the principles in the exposure draft (or in Topic 820) cannot be applied. Furthermore, there should not be a 'fair value for developed economies' and a 'fair value for developing economies'. Only by requiring the use of fair value will practice develop (even if there will be a learning curve in the short term).

29. The forthcoming fair value measurement standard will assume that those applying its concepts have some level of valuation knowledge, for example:

    (a) the ability to assess the 'value drivers' of an asset or liability and to determine which valuation technique or techniques are most appropriate in which circumstance, including knowledge of the strengths and limitations of each valuation technique

    (b) knowledge of how to source data that market participants would use as inputs to valuation techniques, to determine which data is most appropriate (and weigh accordingly) and to assess which sources are more reliable than others[5]

    (c) experience with applying judgement in a particular situation.

[5] By requiring fair value as a measurement basis for an asset or liability, the boards presume that such information is in fact available. See the next section for how the IASB has chosen to address circumstances in which such information is not available.

30. A lack of experienced valuers is not a problem caused by the proposals in the exposure draft, but it is an issue for entities trying to apply the proposals in emerging and transition economies. Indeed, many of the same application issues exist for the definition of fair value and the related guidance in IFRSs today (although some of the explicit proposals in the exposure draft are implicit in the current fair value measurement guidance, eg assessing the highest and best use of an asset and making assumptions that market participants would make in the circumstances).[6]

31. However, we have received questions about how to apply the proposals from entities in developed economies, too. In particular, entities around the world would like guidance to improve consistency in developing Level 3 fair value measurements (eg intangible assets acquired in a business combination).

32. The staff thinks this is appropriate because many we have talked to know how to do valuations for pricing purposes (eg for transactions), but not for accounting purposes. For accounting purposes, they are used to using market prices if they are available, but if market prices are not available, they use cost.

33. The biggest issue seems to be a discomfort with using judgement, not with performing valuations. For example, they are uncomfortable assessing *the* highest and best use of an asset, determining *the* principal (or most advantageous) market and identifying *the* relevant types of market participants to determine *the* fair value.

34. Entities seem to be comfortable with measuring fair value when it is derived from a quoted price in an active market. But as soon as it becomes necessary to estimate fair value or to make adjustments to quoted prices (eg due to restrictions), they are unsure what to do. There is a perception that fair value cannot be measured using unobservable inputs, and there is a concern that Level 3 fair value measurements decrease consistency across entities. This is because of the judgement involved with:

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[6] Although the proposals in the exposure draft are not materially different from the current fair value measurement guidance in IFRSs, some entities in emerging and transition economies are not currently applying IFRSs. For those entities, any similarities between the current fair value measurement guidance and the proposed guidance is irrelevant.

(a) selecting the valuation technique to use (which might differ from entity to entity) and

(b) selecting the inputs to the valuation technique.

Format of educational material

35. The staff thinks it would be useful for the IASC Foundation to publish a document similar to the IASB's fair value Expert Advisory Panel report, which is a summary of practice for measuring the fair value of financial instruments in inactive markets.[7] That document was not a detailed 'how to' valuation guide, but it summarised the thought process for performing valuations and emphasised the need for judgement when measuring fair value in the absence of a quoted price.

36. Educational material about measuring fair value in IFRSs could, for example, describe the thought process for:

    (a) assessing the highest and best use of an asset

    (b) determining what to take into consideration when quantifying restrictions on the sale or use of an asset

    (c) selecting methodologies for measuring the fair value of unquoted equity instruments

    (d) determining which observable inputs are relevant to a valuation

    (e) using unobservable inputs in a fair value measurement.

37. The issues covered in the educational material would be based on those raised in the responses to the request for input and through other sources.

Timing of educational material

38. The staff envisages that the IASC Foundation would publish the educational material shortly after the publication of an IFRS on fair value measurement.

[7] In October 2008, the IASB's Expert Advisory Panel published *Measuring and disclosing the fair value of financial instruments inn markets that are no longer active*.

This would allow sufficient time for entities preparing to adopt the fair value measurement standard to have the educational material available to them during that process.

39. We expect that a draft document would be posted on the IASB website for interested parties to provide feedback on the guidance that has been developed. After receiving that feedback, the staff would finalise the document for publication by the IASC Foundation.

Question
Do the boards have any comments on the staff's plan for publishing educational material to accompany an IFRS on fair value measurement?