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| | **IASB/FASB Joint Meeting – 17-18 November 2010** | IASB Agenda reference | **2A** |
| Staff Paper | **FASB ED Session – November 10, 2010** | FASB Agenda reference | **18** |
| Project | **Fair value measurement** | | |
| Topic | **Measuring the fair value of a reporting entity's own equity instruments** | | |

## Purpose of this paper

1. This paper addresses measuring the fair value of a reporting entity's own equity instruments.

2. This paper asks the boards to determine whether the proposed fair value measurement guidance for liabilities is equally applicable when measuring the fair value of a reporting entity's own equity instruments (eg in a business combination when an acquirer issues equity as consideration for the acquiree).

## Summary of the proposals

3. The FASB's exposure draft of a proposed Accounting Standards Update (ASU) *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* states that the objective of a fair value measurement for an instrument classified in a reporting entity's shareholders' equity is to estimate an exit price from the perspective of a market participant who holds the instrument as an asset at the measurement date. This is because the issuer of an equity instrument can exit from that instrument only if the instrument ceases to exist or if the reporting entity repurchases the instrument from the holder.

4. This proposal is consistent with the guidance proposed by the IASB in its May 2009 exposure draft *Fair Value Measurement* and is identical to the IASB staff draft of a forthcoming IFRS on fair value measurement posted on the IASB website in August 2010.

## Overview of comments received

5. The Questions for Respondents accompanying the FASB's exposure draft asked interested parties whether they agree with the proposed guidance for measuring the fair value of an instrument classified within shareholders' equity.

6. Many respondents agreed with the proposed guidance to measure the fair value of a reporting entity's own equity from the perspective of a market participant that holds the instrument as an asset at the measurement date. They welcomed the additional guidance and note that current practice is to measure a reporting entity's own equity (eg in a business combination) in the manner proposed.

7. Furthermore, some respondents think measuring the fair value of a reporting entity's own equity should be consistent with measuring the fair value of liabilities and therefore asked for clarification about the proposal. For example, some noted that there is an overlap between measuring the fair value of a reporting entity's own equity when the equity instruments are traded as an asset and measuring the fair value of an entity's liability when the debt instrument is traded as an asset. Those respondents ask whether they can (or should) analogise to the proposed guidance with respect to valuing liabilities using the quoted price of the liability when traded as an asset (including when it is appropriate to adjust the quoted asset price).

## Staff analysis and recommendations

8. The staff thinks that, although liabilities and equity are not the same, they both are claims against the assets of an entity and their measurement would have many similarities. As a result, the staff thinks the boards did not intend to preclude an entity from using the guidance for measuring the fair value of liabilities when measuring the fair value of a reporting entity's own equity instruments.

9. However, the staff thinks that although the measurement of liabilities and a reporting entity's own equity instruments are similar in some respects, the two types of instruments are not the same and that it is necessary to ensure that the fair value measurement standard is clear which guidance for measuring the fair value of liabilities is equally applicable when measuring the fair value of a reporting entity's own equity instruments.

10. Although the valuation process for an entity's own equity instruments is already addressed in the fair value measurement principles in Topic 820 *Fair Value Measurements and Disclosures*, the staff has identified the following principles from the proposed guidance in the FASB's exposure draft that is

applicable to liabilities and that would also be applicable to a reporting entity's own equity instruments (the entire section on measuring the fair value of liabilities in the FASB's exposure draft is in the appendix to this paper):

(a) when a quoted price in an active market for the transfer of the identical equity instrument is not available, a reporting entity would measure the fair value of the equity instrument as follows:

  (i) using the quoted price in an active market for the identical equity instrument held by another entity as an asset, if that price is available.

  (ii) if that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical equity instrument held by another entity as an asset or quoted prices for similar equity instruments held by other entities as assets.

  (iii) if observable inputs are not available, using another valuation technique, such as an income approach or a market approach.

(b) a reporting entity should adjust the quoted price of the equity instrument held by another entity as an asset for factors specific to the asset that are not applicable to the fair value measurement of the equity instrument. Although the exit price from the perspective of a market participant who holds the instrument as an asset is a good starting point, there may be circumstances in which the reporting entity should adjust that price in valuing its own equity instruments. For example, an adjustment would be necessary when the quoted price for the asset relates to a similar (but not identical) equity instrument held as an asset.

11. The staff thinks it is important to emphasise for both liabilities and equity instruments that the following requirements must be followed:

(a) maximise the use of relevant observable inputs and minimise the use of unobservable inputs;

(b) apply the guidance for measuring fair value when the volume and level of activity for a liability or an equity instrument have significantly decreased and when identifying transactions that are not orderly; and

(c) use the assumptions that market participants would use when pricing the identical liability or equity instrument in the principal (or most advantageous) market.

12. The staff thinks it is also necessary to include guidance about determining the level in the fair value hierarchy in which a fair value measured in this way would be categorised. This guidance would state that when measuring the fair value of the equity instrument using the quoted price for the identical equity instrument traded as an asset in an active market, that price would result in a Level 1 fair value measurement when no adjustments to the quoted price of the asset are required. In some cases, a reporting entity may need to adjust the quoted price for the asset for factors specific to the equity instrument and the asset. However, the guidance needs to be made clear that any adjustment to the quoted price of the asset would result in a fair value measurement categorised within a lower level of the fair value hierarchy.

13. Furthermore, for both liabilities and equity instruments, the boards have concluded that the objective is to estimate an exit price from the perspective of a market participant who holds the corresponding asset at the measurement date, regardless of whether that asset is traded (eg on an exchange).[1] As a result, rather than referring to a liability being *traded in the marketplace* as an asset (the current terminology in Topic 820), the FASB's exposure draft and

[1] The FASB's Valuation Resource Group (VRG) discussed this at its 1 November 2010 meeting. Most members of the VRG indicated that this is consistent with current practice (even though Topic 820 today is not explicit on this point).

the IASB staff draft refer to a liability being *held by another entity* as an asset. The staff thinks this can be made explicit in drafting.

***Staff recommendation***

14. The staff recommends that the final fair value measurement standard acknowledge that although equity instruments are different from liabilities, the guidance for measuring their fair value is the same in some respects, as described in paragraphs 10-13 above.

| **Question 1** |
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| Do the boards agree with the staff recommendation in paragraph 14?<br><br>If not, what do you propose and why? |

## Appendix: Proposed Guidance for Measuring the Fair Value of Liabilities

Please note:

- Paragraph numbering is not sequential because some of the paragraphs in the ASU have been superseded.
- This guidance for liabilities is identical to the guidance in the IASB staff draft of a forthcoming IFRS on fair value measurement (except for some of the guidance about third-party credit enhancements. The IASB will discuss third-party credit enhancements at a future meeting).

### *Application to Liabilities*

820-10-35-15B Paragraphs 820-10-35-16 through 35-18D describe the fair value measurement of financial and nonfinancial liabilities.

*General Principles*

820-10-35-16 A fair value measurement assumes that:

a. The liability, whether it is a financial liability or a nonfinancial liability, is transferred to a market participant at the measurement date (that is, the liability would continue and the market participant transferee would be required to fulfill the obligation; it would not be settled with the counterparty or otherwise extinguished on the measurement date).

820-10-35-16A In many cases, there will not be an observable market to provide pricing information for the transfer of a liability because there are often contractual or other legal restrictions preventing the transfer of a liability. However, in some cases, a liability (for example, a debt obligation) is held by another entity as an asset.

820-10-35-16B When a quoted price in an active market for the transfer of the identical liability is not available, a reporting entity shall measure the fair value of the liability as follows:

c. Using the quoted price in an active market for the identical liability held by another entity as an asset, if that price is available

d. If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical liability held by another entity as an asset or quoted prices for similar liabilities or similar liabilities held by other entities as assets.

e. If observable inputs are not available, using another valuation technique, such as:

1. An income approach (for example, a present value technique that takes into account the future cash outflows that market participants would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation, as described in paragraph 820-10-35-16H through 35-16I)

2. A market approach (for example, using the amount that a market participant would pay to transfer the identical liability or would receive to enter into the identical liability, as described in paragraph 820-10-35-16J).

820-10-35-16C In all cases, a reporting entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs. Furthermore, a reporting entity shall apply all applicable guidance in this Topic when measuring fair value when the volume and level of activity for a liability have significantly decreased and when identifying transactions that are not orderly.

820-10-35-16D A reporting entity shall adjust the quoted price of a liability held by another entity as an asset for factors specific to the asset that are not applicable to the fair value measurement of the liability. Some factors that may indicate that 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 held as an asset (for example, if the liability has a credit quality different from that reflected in the fair value of a similar liability held 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 paragraphs 820-10-35-18A through 35-18B for further guidance.

820-10-35-16DD However, in the absence of factors that indicate that the quoted price of the asset should be adjusted (such as those listed in paragraph 820-10-35-16D), when measuring the fair value of a liability using the quoted price of the liability held by another entity as an asset, a reporting entity shall not adjust the price of the asset for the effect of a restriction preventing the sale of that asset.

820-10-35-16G When observable inputs are not available and a reporting entity measures the fair value of a liability using another valuation technique, a reporting entity shall ensure that the fair value is consistent with the objective of a fair value measurement, that is, to estimate the price at which an orderly transaction to transfer the liability would take place between market participants at the measurement date.

820-10-35-16H When using a present value technique (see paragraph 820-10-35-16B(e)(1)), a reporting entity shall, among other things, estimate the future cash outflows that market participants would expect to incur in fulfilling the obligation. Those future cash outflows shall include the direct and indirect costs of fulfilling the obligation and the compensation that a market participant would require for taking on the obligation. Such compensation includes the return that a market participant would require for undertaking the activity (that is, the value of fulfilling the obligation; for example, by using resources that could be used otherwise) and for assuming the risk associated with the obligation (that is, the risk that the actual cash outflows ultimately might differ from the expected cash outflows).

820-10-35-16I That compensation might be reflected in the fair value of a liability in different ways. For example:

a. A financial liability contains a contractual rate of return reflecting both the compensation for undertaking the activity and the compensation for assuming the risk associated with the obligation at inception. At the measurement date, a reporting entity shall determine whether the contractual rate of return reflects the compensation market participants would require for taking on the obligation (that is, for undertaking the activity and for assuming the risk associated with the obligation).

b. A nonfinancial liability does not contain a contractual rate of return and there is no observable market yield for such liabilities. Therefore, a reporting entity shall estimate the return market participants would require for undertaking the activity and for assuming the risk associated with the obligation. In some cases, those components will be indistinguishable from one another (for example, when using the price a third-party contractor would charge on a fixed fee basis). In other cases, a reporting entity needs to estimate them separately (for example, when using the price a third-party contractor would charge on a cost plus basis because the contractor in that case would not bear the risk of future changes in costs).

820-10-35-16J When using a valuation technique that takes into account the amount at the measurement date that the reporting entity would receive to enter into the identical liability (see paragraph 820-10-35-16B(e)(2)), the inputs shall reflect the assumptions that market participants would use when pricing the identical liability in the principal (or most advantageous) market for issuing a liability with the same contractual terms.

*Nonperformance Risk*

820-10-35-17 The fair value of a liability reflects the effect of nonperformance risk. Nonperformance risk includes, but may not be limited to, a reporting entity's own credit risk. Nonperformance risk is assumed to be the same before and after the transfer of the liability.

820-10-35-18 When measuring the fair value of a liability, a reporting entity shall consider the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will not be fulfilled. That effect may differ depending on the liability, for example:

a. Whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a nonfinancial liability)

b. The terms of credit enhancements related to the liability, if any. Paragraph 820-10-55-56 illustrates the effect of credit risk on fair value measurement of a liability.

820-10-35-18A The issuer of a liability with an inseparable third-party credit enhancement shall not include the effect of the credit enhancement in the fair value measurement of the liability. For 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.

820-10-35-18B The guidance in the preceding paragraph does not apply to any of the following instruments or transactions:

a. A credit enhancement provided by a government or government agency (for example, deposit insurance)

b. A credit enhancement provided between a parent and its subsidiary

c. A credit enhancement provided between entities under common control.

*Restriction Preventing the Transfer of a Liability*

820-10-35-18C When measuring the fair value of a liability, a reporting entity shall not include a separate input or an adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The effect of a restriction that prevents the transfer of a liability would have been either implicitly or explicitly already included in the other inputs to the fair value measurement.

820-10-35-18D For example, at the transaction date, both the creditor and the obligor are willing to accept the transaction price for the liability with full knowledge that the obligation includes a restriction that prevents its transfer. As a result of the restriction already being included in the transaction price, a separate input or adjustment to an existing input into the fair value measurement of a liability is not required at the transaction date to reflect the effect of the restriction on transfer. Additionally, a separate input or adjustment to other inputs into the fair value measurement of a liability is not required at subsequent measurement dates to reflect the effect of the restriction on transfer.