IASB/FASB Joint Meeting
– week beginning 18 October 2010

IASB Agenda reference **2E**

Staff Paper

FASB ED Session
– October 13, 2010

FASB Agenda reference **16**

Project	**Fair value measurement**
Topic	**Addressing concerns about the unit of account**

Purpose of this paper

1. This paper addresses whether it is necessary to use the highest and best use and valuation premise concepts when measuring the fair value of financial instruments because of a lack of unit of account guidance in specific circumstances.

2. This paper asks the boards to:

   (a) emphasis that the notion of value maximisation is a fundamental principle in fair value measurement; and

   (b) clarify the unit of account in specific circumstances, including:

      (i) for IFRSs, for investments in associates, subsidiaries and jointly-controlled entities; and

      (ii) for US GAAP, for investments in debt and equity securities held by investment companies.

   Appendix A to this paper summarises the standards for which there are concerns about unit of account.

3. Please note that this paper does <u>not</u> address blockage factors or control premiums. The staff will prepare a separate paper on premiums and discounts

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(including blockage factors and control premiums) and will present that paper at a future meeting.

4. For reference, Appendix B to this paper contains the rationale for the following conclusions reached so far by the boards:[1]

   (a) the highest and best use concept is not relevant for financial assets or for liabilities;

   (b) the valuation premise concept (in particular, the premise for assets used in combination with other assets and liabilities) is not relevant for financial assets or for liabilities; and

   (c) the application of premiums and discounts depends on the unit of account specified in another standard.

   Many respondents to the FASB's exposure draft agreed in principle with these conclusions.

Background

5. The first step when measuring fair value is to determine 'what is being measured'. The determination of 'what' takes into account the asset or liability that another standard specifies is to be measured at fair value. The question of 'what is that asset or liability' must be answered before its fair value can be determined. This project depends on the unit of account being clear in other standards.[2]

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[1] Please note that the proposals on these topics in the FASB's exposure draft are identical to the staff draft of an IFRS on fair value measurement.

[2] Before FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) was published in US GAAP (and before an IFRS on fair value measurement is published), the measurement and application guidance about estimating fair value resided in the standards that used it as a measurement basis. Because the measurement guidance in each standard was specific to the assets and liabilities subject to the measurement, there was little confusion about the relationship between the guidance for measuring fair value and the subject of the measurement (ie the asset or liability).

6. After reading the comment letters in response to 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*, it seems clear that some have been using valuation guidance to answer unit of account questions when the unit of account for an asset or liability either (a) is not clear or (b) is not consistent with the level at which an exit transaction would actually take place between market participants.

7. In other words, practice has addressed any ambiguity about unit of account by using the fair value measurement guidance, namely the concepts of highest and best use and the valuation premise, instead. The staff thinks this is not what the boards intend.

8. Some are concerned that when the boards stated that the concepts of highest and best use and the valuation premise are not relevant for financial instruments, they removed the notion of value maximisation by market participants (see paragraphs 14-17 below). The staff thinks it is clear that the notion of value maximisation is a fundamental principle in fair value measurement and that the boards can address these concerns through drafting.

9. The real problem is the unit of account for some financial instruments.

10. The unit of account for most financial instruments is clear—IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 9 *Financial Instruments*, Topic 815 (Derivatives and Hedging) and Topic 825 (Financial Instruments) are clear that the unit of account for a fair value measurement is the individual financial asset or financial liability. The appropriateness of the resulting accounting answer is a subject of debate, but that debate is not for this project.[3]

[3] With regard to fair value measurement, the boards have consistently concluded that the sum of the fair values of individual financial instruments will not differ from the fair value of a group made up of those instruments. This is because the price of each of the instruments within the group would reflect the benefits that market participants would derive from holding the asset in a diversified portfolio. This paper does not ask the boards to reconsider that decision.

11. The staff does think, however, that there are particular financial instruments for which the unit of account was not meant to be each individual financial asset or financial liability. There is a tension between the accounting for investments in other entities when those investments take the form of debt and equity instruments and when the fair value of debt and equity instruments is meant to be measured on an individual instrument basis. For example:

    (a) in IFRSs, this problem arises in IAS 27 *Consolidated and Separate Financial Statements* (paragraph 38), IAS 28 *Investments in Associates* (paragraph 1) and IAS 31 *Interests in Joint Ventures* (paragraph 1) when measuring the fair value of investments in subsidiaries, associates or jointly controlled entities in accordance with IAS 39 or IFRS 9. This might also be a problem in IFRSs pending the outcome of the project on investment companies; and

    (b) in US GAAP, this problem arises in Topic 946 (Financial Services—Investment Companies) for investments in debt and equity securities held by investment companies.

12. It seems that further guidance is required about whether the unit of account for an 'investment' is the *entire investment* or the *individual debt and equity securities* underlying that investment.

Staff analysis and recommendation

13. This section:

    (a) analyses the notion of 'value maximisation' in a fair value measurement;

    (b) summarises the problem when measuring the fair value of an 'investment'; and

    (c) sets out the staff's recommendations.

The notion of value-maximising behaviour

14. Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability. The definition of market participants states that they must be willing to enter into a transaction for the asset or liability. That is, both the buyer and the seller must be willing to enter into a transaction. The only way both parties will be willing to enter into a transaction is if both think they are transacting at the best price—the buyer is buying at a price that allows it to maximise cash inflows from the asset (or minimise cash outflows from the liability) and the seller is selling (or transferring) at a price that allows it to earn a sufficient return on the asset (or liability).

15. Finance theory holds that investment decisions are made to maximise shareholder wealth. Entities do that by maximising the net present value of their investments (whether they are investments in tangible or intangible assets or in financial instruments).

16. The fair value measurement proposals *explicitly* address investments in tangible and intangible assets by stating that the highest and best use of such assets should be determined by considering whether their value is maximised by using them in combination with other assets or by using them on a standalone basis.

17. The fair value measurement proposals *implicitly* address investments in financial instruments through the definition of market participants and their reliance on finance theory. Respondents to the FASB's exposure draft are asking that this be made explicit. The staff thinks this can be addressed in drafting.

Measuring the fair value of an 'investment'

18. As noted above, the first step when measuring fair value is to determine 'what is being measured', which is specified in another standard. When the unit of account for a particular asset or liability is not specified, some applying US GAAP appear to have been using the highest and best use and valuation premise concepts to determine how assets and/or liabilities would be grouped in a

transaction between market participants (particularly given that most assets and liabilities are not transacted individually in practice). They have been doing this for financial and non-financial assets and liabilities.

19. For the financial assets and financial liabilities accounted for in IAS 39, IFRS 9, Topic 815 and Topic 825, any difference between the specified unit of account and the level at which a transaction for the asset would take place should be irrelevant because, as noted above, the boards have concluded that for financial instruments, there should be no difference in value. This is because the price of each of the instruments within the group would reflect the benefits that market participants would derive from holding the asset in a diversified portfolio.

20. Although there are some who disagree with this approach (because transactions do not normally take place for individual financial assets and financial liabilities), the staff does not suggest addressing the unit of account for financial instruments in this project.

21. However, the boards have received questions about the unit of account for items measured at fair value that are comprised of multiple individual financial instruments—that is, people want to know what they are measuring when measuring the fair value of an 'investment'.

22. **Please note that we are talking about investments in associates, subsidiaries and jointly controlled entities accounted for in IAS 27, IAS 28, IAS 31 and investments in debt and equity securities accounted for in Topic 946. We are <u>not</u> talking about investments in financial instruments accounted for in IAS 39, IFRS 9, Topic 815 and Topic 825.**

23. Consider the following example for a description of the problem.

> Entity A is an investment company / parent company. It owns 100% of the equity securities of Entity B and has issued to Entity B a debt instrument with a change of control provision specifying that Entity B must pay the full principal amount of $10 to Entity A if and when the change in control provision is triggered (it is assumed that Entity B has sufficient assets to repay the debt).

Entity A must measure the fair value (exit price) of its investment in Entity B.

Entity A determines that the enterprise value (fair value of total assets) of Entity B is \$100, which is determined on a controlling interest basis. Entity A then determines that the fair value of 100% of the equity if Entity B is \$90 (\$100 minus \$10, which is the total amount of the debt due upon a sale of a controlling interest in the equity of Entity B).

The fair value of the debt instrument, if it were not held by Entity A, may not be \$10, because it would reflect, among other things, the difference between the contractual interest rate and the current market interest rate. It also would reflect market participant expectations about a future change in control. Assume the fair value of the debt instrument if it were held by another party is \$8.

24. There are two questions that must be answered:

    (a) firstly, does the 'fair value of Entity A's investment' represent:

        (i) the fair value of its entire holding in the debt and equity securities of Entity B (\$100) or

        (ii) the fair value of the debt instrument (\$8) plus the fair value of the equity securities (\$90), for a total of \$98?[4]

    (b) secondly, does the 'fair value of Entity A's investment' in the *equity securities* of Entity B represent:

        (i) the fair value of Entity A's entire holding (\$90) or

        (ii) the sum of the fair values of each individual instrument comprising the holding (\$90 minus the control premium)?

Staff recommendation

25. The staff thinks the answers to the questions in paragraph 24 are outside the scope of the fair value measurement project. Therefore, the staff recommends

[4] The difference in fair value of \$2 represents, among other things, the difference between the contractual interest rate and current market interest rate and expectations about a future change in control.

addressing the unit of account for such investments separately from the fair value measurement project.

26. The focus of the fair value measurement project is on 'how' to measure fair value and not on 'what' is being measured at fair value. The boards have worked very hard to ensure that the project is about defining fair value and providing guidance about 'how' to measure it, and not about determining 'what' is measured at fair value or 'when' fair value should be used.

Question 1
Do the boards agree with the staff recommendation in paragraph 25? If not, what do you propose and why?

Appendix A

1. The following 'investments' are measured at fair value in IFRSs and US GAAP:

IFRSs	US GAAP
• **IAS 27.38:** Investments in subsidiaries, associates and joint ventures in the parent's separate financial statements in accordance with IAS 39 or IFRS 9 • **IAS 28.1:** Investments in associates held by venture capital organisations or mutual fund and similar entities that are measured in accordance with IAS 39 or IFRS 9 • **IAS 31.1:** Interests in jointly-controlled entities held by venture capital organisations or mutual fund and similar entities that are measured in accordance with IAS 39 or IFRS 9	• **946-320-35-1:** Investments in debt and equity securities held by investment company entities

2. This might also be a problem in IFRSs pending the outcome of the project on investment companies.

Appendix B

Highest and best use

1. The boards have concluded that the highest and best use concept is not relevant for financial assets or for liabilities because:

   (a) Financial assets do not have alternative uses because a financial asset can only have a different use if the characteristics of the financial asset are changed. However, this causes that particular asset to become a different asset. The objective of a fair value measurement is to measure the asset that exists at the measurement date.

   (b) Even though an entity may be able to change the cash flows associated with a liability by discharging it in different ways, the different ways of discharging a liability are not alternative uses. Moreover, although an entity might have entity-specific advantages or disadvantages that enable it to fulfil a liability more or less efficiently than other market participants, those entity-specific factors do not affect fair value.

Valuation premise

2. The boards also concluded that the valuation premise concept is not relevant for financial assets or for liabilities because the intent of the valuation premise concept 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.

3. This is not a necessary assumption for financial assets or for liabilities because:

   (a) Grouping financial assets does not change the expected cash flows of a particular financial asset within the group, even though that asset may be negatively correlated with another. In an efficient market, the price would reflect the benefits that market participants would derive from holding the asset in a diversified portfolio. Therefore, an entity will obtain no incremental benefit from holding the asset in a portfolio.

(b) A market participant transferee would not demand a different amount to assume a liability just because there are different assets backing that claim. In determining the price it will demand to assume an obligation, a market participant will take into consideration the repayment or other performance of the obligation.

4. Furthermore, if the highest and best use concept is not relevant for financial assets or for liabilities (financial or non-financial), and the highest and best use determines the valuation premise, then it is not meaningful, and thus, not appropriate, to apply the valuation premise to financial assets and to liabilities.

Application of premiums and discounts

5. In addition, the boards decided that the inputs to a valuation technique depend on the unit of account, as specified in other standards, for the asset or liability. As such, a control premium, for example, would be relevant when measuring the fair value of a controlling interest in another entity. The boards also decided to prohibit the application of a blockage factor, which is the potential effect on an observed market price that might result from supply and demand imbalances in the principal market if an entity were to sell a large holding of, for example, equity securities, in Level 1 of the fair value hierarchy.

6. The boards also specified that because blockage factors are determined on the basis of a change in an observable market price, they are not relevant when a fair value measurement uses a valuation technique that does not use an observable market price as a main input. For example, a blockage factor would not be relevant for a Level 3 fair value measurement that is estimated using a discounted cash flow approach because there would be no basis for making an 'adjustment to a price' as there is *no observable market price to affect*.