International Accounting Standards Board

Breakout Session: Fair Value Measurement

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Disclaimer

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenters. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

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Agenda

- The objective of financial reporting—how does fair value fit in?
- Fair value measurements initiated by the IASC and the IASB
- Why have an IFRS on fair value measurement?
- Overview of SFAS 157
- Main differences between SFAS 157 and IFRSs
- Deliberations to-date
- Next steps in the IASB's fair value measurement project
- Appendix: Discussion paper comment letter summary

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Objective of financial reporting

To provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions

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Objective of financial reporting

- **The decision-usefulness objective is not limited to information useful for buy, sell or hold decisions**
- **Also includes information useful in assessing management's stewardship and accountability**
  - ***Helps decide whether to replace or reappoint management, management remuneration, how to vote on management proposals, etc.***

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Qualitative characteristics

- **Relevance**
  - ***Capable of making a difference to a user's decision***
  - ***Has predictive value***
- **Faithful representation (reliability)**
  - ***Reflects real-world economic phenomena***
  - ***Encompasses verifiability, neutrality and completeness***
- **Comparability**
  - ***Enables users to identify similarities and differences***
  - ***It is undesirable for similar events to look different***
- **Understandability**
  - ***Enables knowledgeable users to comprehend the meaning of the measurement***

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Addressing common misunderstandings

- **Conservatism is not a qualitative characteristic of accounting information**
- **Matching is not an objective of accounting measurement, it is an outcome**
- **Reliability is not limited to verifiability, and it does not mean precision**

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Addressing common misunderstandings

- **The objective of financial reporting is not to help management to manage the business**
- **The *Framework* focuses on assets and liabilities because they define profit and loss**
- **The Board does <u>not</u> have an objective to measure all assets and liabilities at fair value**

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How fair value fits into this approach

- **Meets *Framework*'s qualitative characteristics**
  - ***Relevant – provides feedback value, timely***
  - ***Faithful representation – consistent with asset and liability definitions, neutral***
  - ***Comparable, enhances consistency***
- **Offers an internally consistent approach to measurement**
- **But other measurements also fit those criteria**

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How fair value fits into this approach

- **Fair value is not perfect**
  - ***It currently lacks a clear definition***
  - ***There are concerns about verifiability***
  - ***There is scope for managerial discretion (judgment)***
  - ***There seems to be circularity when using fair values for financial reporting when the objective is to provide information to users to, among other things, assess value***

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Fair value measurements established by the IASC

	Required	Optional
Initial recognition	▪ Finance leases (lessee) ▪ Financial instruments ▪ Business combinations (IAS 22)	
Recurring measurement	▪ Some financial instruments (AFS, trading, derivatives) ▪ Pension and post-retirement plan assets ▪ Impairment (higher of fair value less costs to sell or value in use) ▪ Agricultural assets	▪ Revaluation model for intangible assets and PP&E ▪ Non-monetary government grants ▪ Investment property

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Fair value measurements established by the IASB

	Required	Optional
Initial recognition	▪ Share-based payments (fair value based) ▪ Expansion of business combination model (IFRS 3/ IFRS 3R) ▪ Insurance liabilities acquired in a business combination	▪ Fair value as deemed cost upon transition to IFRSs
Recurring measurement	▪ Non-current assets held for sale	▪ Fair value option for financial instruments

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Where is the Board considering current values?

Fair Value	Other Current Values
▪ Revenue recognition ▪ All financial instruments at fair value through profit and loss	▪ Revenue recognition (customer consideration model) ▪ Liabilities under IAS 37 (current settlement amount) ▪ Insurance contracts (current exit value)

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Why have an IFRS on fair value measurement?

- **Clarify the fair value measurement objective in current IFRSs**
- **Develop a single source of guidance for all fair value measurements**
  - ***Eliminate dispersed and inconsistent fair value measurement guidance from IFRSs***
  - ***Individual standards might retain specific guidance***
- **Improve and harmonise the disclosures for fair value measurements**

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The starting point

- **The FASB was nearing completion of SFAS 157 when the IASB began working on a fair value measurement standard**
- **Because of the Memorandum of Understanding, the IASB decided that the most appropriate starting point was to begin deliberations using SFAS 157**

SFAS 157 was used *to initiate comments from constituents*—it is not the 'final solution'.

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SFAS 157 Overview

- **Defines fair value for US GAAP**
- **Establishes the approach for measuring fair value for financial reporting**
- **Enhances disclosures about fair value**
- **Applies when other standards require or permit fair value**
- **Effective for fiscal years beginning after 15 November 2007**
  - ***FASB discussing possible deferral of effective date at its meeting 14 November 2007***

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SFAS 157 Definition of fair value

- **The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date**
- **Assumes a hypothetical exchange transaction**

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SFAS 157
Reference market

- **The market in which *the entity* would sell the asset or transfer the liability**
  - ***The* principal market *is the market with the greatest volume and level of activity for the asset or liability***
  - ***The* most advantageous market *maximises the amount that would be received for the asset or minimises the amount that would be paid to transfer the liability (considering transaction costs)***
- **The reference market is only relevant if the entity has access to more than one market**

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SFAS 157
Market participants

- **Buyers and sellers in the exit market (other entities with whom the entity would transact) who are:**
  - ***Independent of the entity***
  - ***Knowledgeable about the asset or liability***
  - ***Able to transact***
  - ***Willing to transact***
- **A fair value measurement should be based on the assumptions market participants would use in pricing the asset or liability, including assumptions about risk, highest and best use (for assets) and non-performance risk (for liabilities)**
- **It is not necessary to identify specific market participants**

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SFAS 157
Highest and best use (assets)

- **The highest and best use of an asset establishes the valuation premise:**
  - ***In-use: if the asset would provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured)***
    - **Assumes the group of complementary assets is available to the market participants**
  - ***In-exchange: if the asset would provide maximum value to market participants through its use on a stand-alone basis***

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SFAS 157
Non-performance risk (liabilities)

- **The risk that the obligation will not be fulfilled**
- **Includes, but is not limited to, credit risk**
- **Assumed to be the same before and after the transfer of the liability**
  - ***The liability continues after the transfer, it is not settled with the counterparty***

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SFAS 157
Fair value at initial recognition

- **A transaction price represents the price paid to buy an asset or received to assume a liability (an entry price)**
- **A fair value is the price that would be received to sell the asset or paid to transfer a liability (an exit price)**
- **The transaction price might not represent fair value if:**
  - ***The transaction is between related parties***
  - ***The transaction occurs under duress or the seller is forced***
  - ***The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value***
  - ***The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability***

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SFAS 157
Valuation techniques

- **Market approach**
  - ***Uses prices and other information generated by market transactions involving identical or comparable assets or liabilities (including a business)***
- **Income approach**
  - ***Uses valuation techniques to convert market expectations of future amounts (eg cash flows or earnings) to a single present amount (discounted)***
- **Cost approach**
  - ***Based on the amount that currently would be required to replace the service capacity of the asset (current replacement cost)***

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SFAS 157
Fair value hierarchy

- **Prioritises inputs to the valuation techniques**
  - ***Level 1***
    - **Unadjusted quoted prices in active markets for identical assets and liabilities that the reporting entity has the ability to access**
    - **Blockage factors are prohibited on large positions of a single financial instrument**
  - ***Level 2***
    - **Inputs other than quoted prices that are observable for the asset or liability**
  - ***Level 3***
    - **Unobservable inputs for the asset or liability**
    - **Reflects the reporting entity's assumptions about the assumptions that market participants would use in pricing the asset or liability**
- **Inputs are based on the price within the bid-ask spread that is most representative of fair value in the circumstances**

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SFAS 157
Disclosures

- **Recurring basis**
  - **The fair value measurement at the reporting date**
  - **The level within the hierarchy in which they fall**
  - **A roll-forward of level 3 measurements**
  - **Total unrealised gains or losses in the level 3 roll-forward included in earnings attributable assets and liabilities held at the reporting date**
  - **Disclosure of valuation techniques and a discussion of changes to techniques (annual only)**
- **Non-recurring basis**
  - **The fair value measurement recorded during the period and the reasons for the measurement**
  - **The level within the hierarchy in which they fall**
  - **For measurements with significant level 3 inputs, a description of the inputs and the information used to develop the inputs**
  - **Disclosure of valuation techniques and a discussion of changes to techniques (annual only)**

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Main differences between SFAS 157 and IFRSs

- **Definition of fair value (an explicit *exit price* versus a neutral *exchange amount*)**
- **Day-one gains and losses**
- **When inputs are based on bid and ask prices**
- **Determining on which market a fair value measurement should be based**

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Comment letter summary General comments

- **Many agree that a project on fair value measurement is needed**
  - ***Single source of guidance***
  - ***A step toward convergence***
- **Some have concerns about the ability of the IASB to diverge from SFAS 157**
  - ***'This is an example of the IASB adopting US GAAP'***
- **Many find it difficult to discuss <u>how</u> to define fair value without knowing <u>when</u> it will be used**

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Comment letter summary
Issue 1. Guidance in IFRSs

- **Many think fair value is used more extensively in IFRSs than in US GAAP**
  - ***Can a principles-based standard provide sufficient guidance?***
- **Some suggest tailoring the guidance to the specific circumstances in which fair value is used (eg have guidance in each standard)**
- **Many prefer the guidance in IFRSs to that in SFAS 157 because each standard addresses its relevant issues**
  - ***eg IFRS 2, IFRS 3, IAS 36, IAS 39, IAS 40, IAS 41***

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Comment letter summary
Issue 2A. Exit price objective

- **Many agree with the definition of an exit price**
  - ***But they think it describes only one aspect of fair value***
  - ***'Exit price is a "one size fits all" concept'***
- **Many think the exit price concept in SFAS 157 assumes that an active, liquid market exists for all assets and liabilities measured at fair value**
  - ***If it did, the hierarchy would consist of one level—Level 1***
- **Many think an entry price is just as relevant as an exit price and that the main differences between the two are different markets and transaction costs**

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Comment letter summary
Issue 2A. Exit price objective

- **Many think 'fair value' is a family of measurement attributes and should be replaced with terms more descriptive of the measurement basis, for example:**
  - ***Current entry price***
  - ***Current exit price***
- **Others think 'fair value should be retained because:**
  - ***They see little, if any, difference between the two***
  - ***'Fair value' is widely used and understood***
  - ***IFRSs and US GAAP need to use the same terms***

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Comment letter summary
Issue 2A. Exit price objective

- **Some respondents provide examples of differences between SFAS 157 and IFRSs:**
  - ***IFRS 2, IFRS 3, IAS 16, IAS 17, IAS 18 and IAS 38 seem to refer to an entry price rather than an exit price***
  - ***IAS 40 and IAS 41 refer to the market in which the entity transacts or expects to transact rather than the principal market***
  - ***IAS 39 refers to the most advantageous market rather than the principal market***

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Comment letter summary
Issue 2B. Market participant view

- **Many agree that the market participants view in SFAS 157 is consistent with the concepts of 'knowledgeable, willing parties' in an 'arm's length transaction' in IFRSs**
  - ***However, some find the term 'market participant' misleading when there is no market***
- **Some question how the market participant view can be relevant when there is little or no market activity and they must rely on 'hypothetical market participant assumptions'**
- **They wonder how to identify market participants**

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Comment letter summary
Issue 2C. Transfer vs settlement

- **Many question the relevance of measuring liabilities at fair value and prefer a settlement price over a transfer price when:**
  - ***there is no active market on which to base the transfer price***
  - ***the entity has no intention of transferring the liability; and***
  - ***the entity has no ability to transfer the liability***
- **They think the measurement objective for liabilities in IFRSs is based on a settlement price, not a transfer price**
  - ***They differ in whether they think it is a current settlement price or a future settlement price***

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Comment letter summary
Issue 3. Initial recognition

- **Some think the transaction price is the best evidence of fair value unless there is evidence to the contrary**
- **Other respondents think it is not always the best evidence of fair value because entities transact in order to make a profit**
- **Some note that deferring day one gains and losses simply defers them to another period**
  - ***What is the difference between a day one gain or loss and a day two gain or loss?***

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Comment letter summary
Issue 4. Reference market

- **Many think the principal market should be used, and in its absence, the most advantageous market**
- **Some prefer the approach in IAS 41 *Agriculture*, which allows an entity to use 'the market expected to be used'**
  - ***Some think the principal market is the market the entity expects to use***
- **Some ask for clarity on what constitutes a market and what to do when there is no observable market**

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Comment letter summary
Issue 5. Attributes

- **Many agree that a fair value measurement should consider attributes specific to the asset or liability**
  - ***'Otherwise, a different item is being valued'***
- **Many are unsure how to determine which attributes a market participant would consider in pricing an item**
- **Many agree that transaction costs are an attribute of the transaction and not of the asset or liability**
  - ***Some request guidance on what is a transaction cost***

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Comment letter summary
Issue 6. Valuation of liabilities

- **Some question whether the quoted price for a financial liability can in fact be used to measure the transfer price because it is the price in an asset trading market**
- **Some think it is appropriate to reflect the risk of non-performance (including credit risk) in a fair value measurement because liabilities are priced that way**
  - ***However, many are concerned about the counter-intuitive results that occur when there is a change in credit standing***
- **Need guidance on what non-performance risk is**

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Comment letter summary
Issue 7. In-use vs value in use

- **Nearly all think the distinction between the in-use valuation premise and value in use in IAS 36 *Impairment of Assets* is clear**
  - ***Many respondents use the term 'value in use' to mean a current market value based on the entity's use of the asset or liability, not as the purely entity-specific notion in IAS 36***

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Comment letter summary
Issue 8. Fair value hierarchy

- **Many agree with the three-level hierarchy**
  - ***Like that it prioritises market inputs***
- **Practical concerns:**
  - ***Identifying an active market***
  - ***Distinguishing between observable and unobservable inputs***
  - ***Applying 'the entity's own assumptions about assumptions that market participants would use' in level 3***
  - ***The interaction between the hierarchy, principal market and highest and best use***
  - ***The interaction between the hierarchy and valuation techniques***

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Comment letter summary
Issue 9. Blocks of fin. instruments

- **Very few agree with the prohibition of a blockage discount**
  - ***Does not reflect the price an entity could realise upon sale and is inconsistent with an exit price***
  - ***It is a rule, not a principle***
- **Those who agree with the prohibition do so because of the perceived subjectivity in its application**
- **Regardless of whether they agree with the prohibition, they think the provision should apply to all levels of the hierarchy (not just level 1)**

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Comment letter summary
Issue 10. Bid-ask spread

- **Many think a fair value measurement should be based on the price within the bid-ask spread that is most representative of fair value**
  - ***Some wonder how this is consistent with an exit price***
- **Many disagree with a pricing convention unless the difference in fair value is immaterial**
  - ***A pricing convention is a rule, not a principle***
- **Many think the guidance should apply to all levels of the hierarchy, although they wonder how it can be applied outside level 1**

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Comment letter summary
Issue 11. Disclosures

- **Some think it is too soon to address disclosures because too many items need to be deliberated**
- **Many suggest harmonising the disclosures in SFAS 157 with those in IFRS 7 *Financial Instruments: Disclosures***
- **Some think there will be large amounts of disclosures for entities in emerging markets**
  - ***They will have very few level 1 inputs***

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Comment letter summary
Issue 12. Application guidance

- **Many suggest providing additional examples:**
  - ***Non-financial assets (eg PP&E, intangible assets)***
  - ***Financial liabilities (eg how to estimate a transfer price)***
  - ***Non-financial liabilities (eg pension obligations and performance obligations)***
- **They also suggest providing more examples showing the application of level 2 and level 3 inputs**

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Comment letter summary
Issue 13. Other matters

- **The discussion paper does not contain the Board's views on:**
  - ***Transitional provisions***
  - ***Early adoption***
  - ***Reliability thresholds***
  - ***Practicability exceptions***
- **The accounting should be aligned with the circumstances of the business or transaction**
- **The Board should take this opportunity to learn from the implementation of SFAS 157 in the US**

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Deliberations to-date
Preliminary definitions

- **Current entry price**
  - ***The price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants at the measurement date***
- **Current exit price**
  - ***The price that would be received to sell an asset or paid to transfer or settle a liability in an orderly transaction between market participants at the measurement date***
    - **If a liability is transferred, it is assumed to exist beyond the measurement date**
    - **If a liability is settled, it is assumed to cease to exist at the measurement date**

These definitions are for the ***standard-by-standard review*** and are subject to change.

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Next steps

- **Assess whether each use of 'fair value' in current IFRSs has the same measurement objective as the proposed definition**
  - ***If it is not, the Board will consider developing guidance for those other measurement bases***
- **Ongoing deliberations of the issues in the discussion paper**
  - ***December 2007: The Market Participant View***
- **Roundtable discussions will be held in 1H 2008**
- **Hold convergence discussions with the FASB if necessary**
- **Issue an exposure draft of an IFRS that consolidates (and replaces) existing guidance**

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