



ED/2009/5 Fair Value Measurement

Public Discussion
Frankfurt/ Main, 5 June 2009



Preliminary note

Background

- IFRSs requiring fair value measurements provide disparate, limited guidance
- Existing guidance lacks consistency (BC2)
- Project added to agenda in September 2005

Objectives

- Establish a single source of guidance for all fair value measurements
- Clarification of the fair value definition
- Enhance the disclosures about fair value
- Specify **how** should entities measure fair value, **not when** (BC5)



Content

- Fair Value Definition
- The transaction
- The market participants
- The price
- Assets
- Liabilities
- Fair value at initial recognition
- Valuation techniques (incl. Fair value hierarchy, Not active markets)
- Disclosures
- Convergence with US GAAP
- Other issues



Fair Value Definition

“Fair value is 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” (current exit price)



Fair Value Definition: Discussion

Question 1 of the IASB

- Is this definition appropriate?

Recent status of discussions at the German Accounting Standards Board (GASB)

- No support for a general exit price notion
- Exit price is an appropriate basis in limited situations only, e.g. trading and derivatives or items where the sale of an asset and transfer of a liability are intended
- In other situations an entry-price approach would be more appropriate
- Recommendation: replace “fair value” by terms, such as “current exit price” or “current entry price” etc., that more closely reflect the measurement basis and underlying measurement objective for each situation

Your comments?



Fair Value Definition: Inconsistencies

Results of the IASB standard-by-standard review

- Several existing fair value requirements are inconsistent with the exit price notion

Issue	Inconsistencies in...	Proposed solution in ED
1	IFRS 2 Share-based Payment	<i>Fair value</i> replaced by <i>market based value</i>
	As a consequence of 1:	
1a	IFRS 1 (par D2)	<i>Fair value</i> replaced by <i>market based value</i>
1b	IAS 33 (par 47A, example 5A)	<i>Fair value</i> replaced by <i>market based value</i>
2	IFRS 3 (par 29: reacquired rights in a BC)	<i>Fair value</i> replaced by <i>value</i>
3	IAS 39 (par 49: liabilities with a demand feature)	<i>Fair value</i> not replaced; circumstance excluded from scope of the ED (2)

(BC29, D4, D5, D6, D7)

- Further amendments to existing IFRS necessary as a consequence of the standardised fair value definition (e.g. IAS 2 Inventories, IAS 16 Property, Plant and Equipment)



The transaction “*orderly transaction between market participants*”

Orderly transaction

- Exposure to the market for a period before the measurement date... (7)
- ...to allow for marketing activities (7) to more than a single market participant (B11)
- Not a forced transaction (e.g. a forced liquidation or a distress sale)

The market

- Most advantageous market (sale of asset: maximal cash in, transfer of liability: minimal cash out -> entity perspective!(9))
- Transaction cost and transport cost to be considered (8)
- Alternative: market with greatest volume and highest level of activity is the most advantageous market (11)

The transaction at the measurement date

- Hypothetical transaction (12), intent to sell the asset/ transfer the liability is not relevant (BC36)



The transaction: Discussion

Question 3 of the IASB

- Is the most advantageous market approach appropriate?

Your comments?



The market participants

... are buyers/ sellers in the most advantageous market

- No related parties (IAS 24)
- Knowledgeable (sufficiently informed about the asset/ liability to make the decision)
-> no information asymmetry
- Able and willing to enter into the (hypothetical) transaction ⁽¹³⁾

When valuing the asset or liability, consider

- Assumptions market participants would use in pricing the asset or liability ⁽¹⁴⁾

When developing these assumptions, consider

- Characteristics that distinguish market participants generally, considering factors specific to ⁽¹⁴⁾
 - The asset or liability
 - The most advantageous market for the asset or liability and
 - Market participants with whom the entity would enter into a transaction in the most advantageous market



The market participants: Discussion

Question 4 of the IASB

- Is the description of market participants adequately described in the context of the definition?

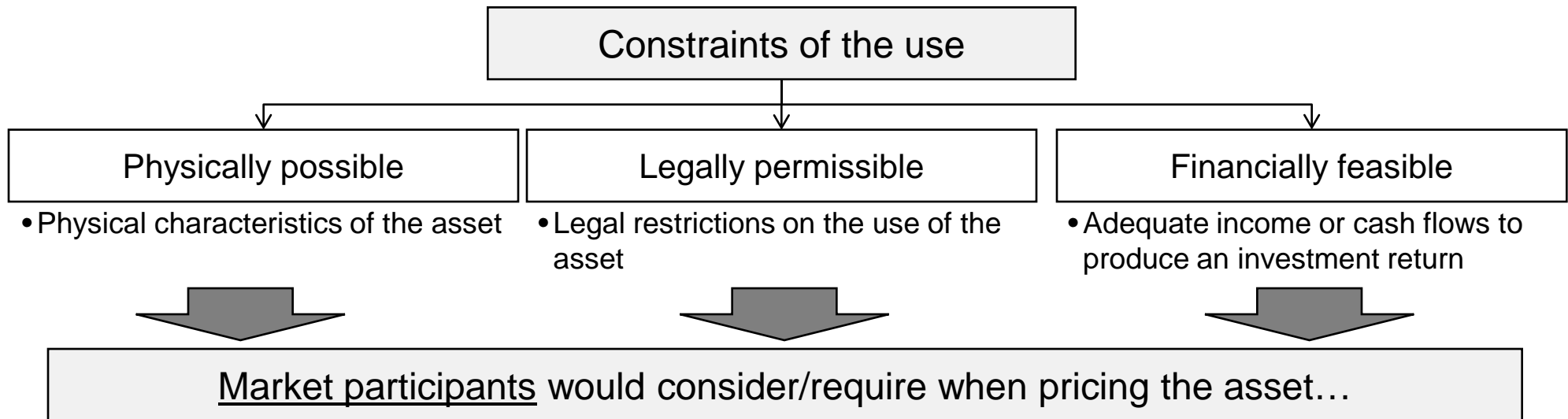
Your comments?



Assets: Highest and best use

Basic notion (17)

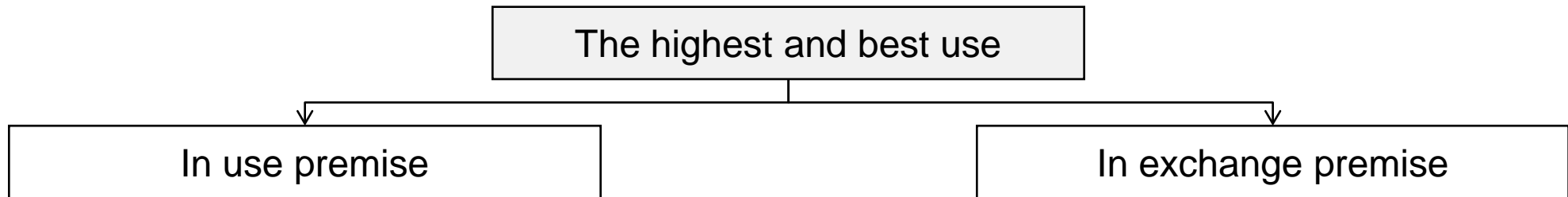
- Sale of the asset to a market participant who will use it in its highest and best use to generate economic benefits
- Maximise the value of the asset (stand-alone or within a group of assets/liabilities)



⇒ ... even if the entity intends a different use! (18) ⇐



Assets: Valuation premise



? How does the asset provide maximum value to market participants ?

- Use in combination with other assets/liabilities as a group
- Price to sell the asset assuming:
 - Market participants would use the asset together with other assets and liabilities as a group
 - Those assets and liabilities would be available to market participants (22a).
- Use on a stand-alone basis
- Price to sell the asset assuming:
 - Market participants would use the asset on a stand-alone basis (22b)
- > **Financial assets** (no definition or reference) are always measured under the in-exchange premise (24)

Overriding premise: asset is sold individually (not as part of a group) (#23)



Assets: Discussion

Question 5 of the IASB

- Are the proposals regarding the measurement of assets
 - Highest and best use
 - Valuation premise (in-use or in-exchange)
 - Financial assets are measured subject to the in-exchange-premise
 - The notions of the highest and best use and the valuation premise are not relevant for liabilities

appropriate?

Your comments?



Liabilities: General principle

Basic notion

- Transfer to a market participant at the measurement date -> exit price, ideally based on observable market price (#25f)

What if

No observable market price for the transfer



Use the same methodology the counterparty uses to measure the **corresponding asset** (#26f)

- Adjust the observed price for the asset for features that are present in the asset but not present in the liability, or vice versa (#27)

No corresponding asset
(e.g. decommissioning liability)



Estimate the price market participants would demand to assume the liability
Use **present value** techniques (#28)

- Estimate the cash flows incurred in fulfilling the obligation
- If known: – Exclude cash flows that other market participants would not incur
– Include cash flows that other market participants would incur but the entity would not incur (#28)



Liabilities: Discussion of the general principle

Question 7 of the IASB

- Are the proposals regarding the measurement of liabilities appropriate?
 - Transfer notion
 - The observed price for financial instruments (as corresponding asset) represents the fair value of the issuers liability (subject to adjustments for special features)
 - In case there is no corresponding asset: estimate the price market participants would demand to assume the liability by using present value techniques

Recent status of discussions at the GASB

- Transfer notion might be relevant for liabilities the entity actually intends to transfer
- For other liabilities the transfer notion does not result in relevant information (that is cash flows resulting from the contract's performance)

Your comments?



Liabilities: Other issues

Non-performance risk (NPR) is reflected by the fair value (#29, 30)

- NPR is assumed to be the same before and after the transfer of the liability
- NPR includes the entity's own credit risk

Restrictions (#31)

- An entity's restriction on the ability to transfer the liability does not affect the fair value (#31)

Equity instruments (#32f)

- Are measured from the perspective of market participant who holds the instrument as an asset
- Rationale: the issuer can exit from that instrument only
 - if the instrument ceases to exist or
 - if the entity repurchases the instrument from the holder



Liabilities: Discussion of other issues

Question 8 of the IASB

- Are the other proposals regarding the measurement of liabilities appropriate?
 - Fair value of a liability reflects non-performance risk
 - Fair value of a liability is not affected by a restriction on the ability to transfer the liability

Recent status of discussions at the GASB

- Considering non-performance risk might be appropriate for liabilities for which the transfer notion might be relevant (liabilities the entity actually intends to transfer)

Your comments?



Fair value at initial recognition

In many cases an entry price equals the exit price at the transaction date (#34f)

- E.g. when the markets (for buying and selling) are identical
- When entry price = exit price (at initial recognition) -> fair value = entry price (at initial recognition)

For example, the entry price is the best evidence of the fair value (initial recognition), unless

- The transaction is between related parties or takes place under duress
- The units of account are differing
- The markets are differing (#36)

When at initial recognition the entry price differs from fair value

- Clarified in the relevant standard for the asset or liability (#37)
- For example -> financial instruments: recognise a “Day 1 gain or loss” only if based on
 - observable current market transactions in the same instrument or
 - a valuation technique whose variables include only data from observable markets. (#BC78)



Fair value at initial recognition: Discussion

Question 9 of the IASB

- Are the proposals appropriate (see slide before)?

Recent status of discussions at the GASB

- From a conceptual point of view, for assets/liabilities carried at an exit price, it would be appropriate that the initial amount recognised might be different from the transaction price, thus resulting in the recognition of day-one gains or losses.

Your comments?



Valuation techniques: 3 approaches

Market approach

- Prices and other information generated by transactions involving identical or comparable assets/liabilities (including a business).
- E.g. market multiples derived from a set of comparables. (#38)

Income approach

- Convert future amounts (eg cash flows or income and expenses) to a single present (discounted) amount.
- Fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts
- E.g. present value techniques, option pricing models (#38)

Cost approach

- Current replacement cost
- The price that would be received for the asset is based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.
- Applied for tangible assets under the in-use premise (#38)

Determining the appropriateness of valuation techniques requires judgement (#BC81)



Valuation techniques: Inputs

= Assumptions that market participants would use when pricing the asset/liability

Observable inputs

- Developed on the basis of available market data (#41)

Unobservable inputs

- Inputs for which market data are not available
- Developed on the basis of the best in information available (#41)

*Maximise the use of relevant observable inputs and
minimise the use of unobservable inputs (#42)*



Valuation techniques: Fair value hierarchy

Level 1

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (#45)
- *Active market*: transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis (#48)
- *Not active market*: see next slide

Level 2

- Inputs other than quoted prices (Level 1) that are observable, either directly (as prices) or indirectly (derived from prices), including
 - Quoted prices for similar assets or liabilities in active markets.
 - Quoted prices for identical or similar assets or liabilities in inactive markets
 - Observable inputs other than quoted prices (e.g. interest rates)
 - Inputs that are derived principally from or corroborated by observable market data (#51)

Level 3

- Inputs that are not based on observable market data (#53)

- 
- Significance of adjustments
 - Level of judgement/ subjectivity



Valuation techniques: Not active markets (1)

Circumstances indicating that a market is not active:

- Significant decrease in volume and level of activity compared to normal activity
- Few recent transactions
- Price quotations are not based on current information
- Price quotations vary substantially over time or among market-makers
- Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability
- Significant increase in implied liquidity risk premiums, yields or performance indicators for observed transactions or quoted prices when compared with the entity's estimate of expected cash flows
- Wide bid-ask spread or significant increase in the bid-ask spread



Valuation techniques: Not active markets (2)

Circumstances indicating that a market is not active (cont'd):

- Significant decline or absence of a market for new issues (ie primary market) for the asset or liability (or similar assets or liabilities).
- Little information is released publicly (#B5)

Consequences

- Objective of a fair value measurement (price that would be received to sell an asset or paid to transfer a liability) remains the same (#B9)
- Intention to continue to hold the asset or liability is not relevant (#B10)
- Transactions or quoted prices may not be determinative of fair value (#B6)
- Significant judgement necessary (e.g. risk premium #B7) (#B10)
- Existence of an inactive market does not imply that all transactions are not orderly (#B11)



Valuation techniques: Not active markets (3)

Circumstances indicating that a transaction is not orderly:

- No adequate exposure to the market for usual marketing activities
- Although marketing possible, the asset or liability was marketed to a single market participant
- Seller is in or near bankruptcy or receivership (distressed) or was required to sell (forced)
- Transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability (#B11)

Consequences

- Transaction price may not be determinative of fair value (#B14)
- Place little weight on the transaction price when valuing the asset/liability (#B12)



Valuation techniques: Bid – ask spread

- Price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value
- Regardless of where the input is categorised in the fair value hierarchy (#55)



Valuation techniques: Discussion

Question 10 of the IASB

- Is the proposed guidance regarding valuation approaches (slide 20), inputs (slide 21), fair value hierarchy (slide 22), not active markets (slides 23-25) and bid-ask spread (slide 26) appropriate and sufficient?

Recent status of discussions at the GASB

- Fair value hierarchy: Support for replacing the 5-level hierarchy in IAS 39 by the 3-level hierarchy in IFRS 7 amend -> same hierarchy implemented in the ED
- Not active markets: Full support
- Bid-ask spread: Using a price within the bid-ask-spread would be inconsistent with an exit price notion. Recommendation: use a bid price for assets and an ask price for liabilities.

Your comments?



Disclosures (1)

Objective: to enable users to assess:

- The methods and inputs used to develop the measurements and,
- The effect of the measurements on profit or loss or other comprehensive income (#56)

Minimum disclosures: For each class of assets and liabilities (#57)

- The fair value measurement at the end of the reporting period.
- The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).
- For assets and liabilities held at the reporting date, any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers.
- The methods and the inputs used in the fair value measurement and the information used to develop those inputs (including changes in a valuation technique, the reason for making that, and its effect on the fair value measurement.)



Disclosures (2)

For each class of assets and liabilities (cont'd)

- For Level 3 measurements: a reconciliation from the opening balances to the closing balances, disclosing separately:
 - i. Total gains or losses for the period through profit or loss, and where they are presented in the statement of comprehensive income
 - ii. Total gains or losses for the period recognised in OCI
 - iii. Purchases, sales, issues and settlements (separately)
 - iv. Transfers into or out of Level 3 and the reasons for those transfers (disclose/discuss significant transfers into Level 3 separately from transfers out of Level 3).
- Total gains or losses in (i) relating to assets and liabilities held at the reporting date
- For Level 3 measurements: a sensitivity analysis (for inputs for which reasonably possible alternative assumptions could result in a significantly different estimate of fair value #BC103)



Disclosures (3)

For each class of assets and liabilities not measured at fair value

(but for which fair value is disclosed)

- Fair value by the level of the fair value hierarchy (#58)

For each class of liability measured at fair value after initial recognition

- a) The amount of change (during the period and cumulatively) in the fair value due to changes in the non-performance risk, and the reasons for that change.
- b) How the amount in a) is estimated
- c) The difference between the liability's carrying amount and the amount of economic benefits the entity is required to sacrifice to satisfy the obligation (#59)



Disclosures (4)

In case the highest and best use of an asset differs from its current use, disclose by class of asset:

- The fair value of the assets assuming their current use were the highest and best use.
- By which the fair value of the assets differs from their value in their current use (incremental value).
- Reasons for the assets are being used differing from their highest and best use. (#60)



Disclosures: Discussion

Question 11 of the IASB

- Are the proposals regarding disclosure requirements (see slides 28-31) appropriate?

Recent status of discussions at the GASB (Comment letter Discussion paper)

- Support for requiring and the main assumptions and description of unobservable inputs for level 3 items.
- In addition to disclosures regarding non-performance risk, disclosures regarding effects from consideration of own credit risk should be required
- In order to determine the costs that entities have to incur in order to comply with these disclosure requirements the IASB should conduct field tests.
- Further empirical research should be conducted in order to gather evidence on the information value of the disclosures for the users.

Your comments?



Convergence with US GAAP (1) (BC110)

Issue	ED Fair Value Measurement	SFAS 157
Scope	Applies to leases Does not apply to – Reacquired rights in a business combination – Financial Liabilities with a demand feature	Does not apply to leases Does apply to – Reacquired rights in a business combination – Financial Liabilities with a demand feature
Reference market	Transaction takes place in the most advantageous market	Transaction takes place in the principal market or in the most advantageous market (in the absence of the principal market)
Highest and best use	Disclosures for circumstances when the actual use of assets differs from the highest and best use	No such disclosures
Blockage factors	Silent on the unit of account for financial instruments (addressed in IAS 39 -> unit of account is the individual instrument, for all levels)	Specifies the unit of account for level 1 financial instruments to be the individual instrument



Convergence with US GAAP (2)

Issue	ED Fair Value Measurement	SFAS 157
Day 1 gains/losses	ED defers to relevant standards for the asset or liability (e.g. IAS 39)	Recognition of Day 1 gains/losses implicitly required in general
Valuation premise and financial instruments	ED states explicitly that the in-use valuation premise is not relevant to financial assets	No such statement
Measurement of liabilities	Comprehensive guidance (keep to the measurement of the corresponding asset of the counterparty)	Less guidance than in the ED
Measurement of equity instruments	ED discusses how to apply the exit price notion to equity instruments measured at fair value	No such discussion



Convergence with US GAAP: Discussion

Question 12 of the IASB

- Do you agree that the approach that the exposure draft proposes for diverging issues is more appropriate than the approach in SFAS 157?
- Are there other differences that we have not identified and that could result in significant differences in practice?

Your comments?

Question 13 of the IASB

- Do you have any other comments on the proposals in the exposure draft?



Other issues: Transaction cost

Transportation cost: considered

- Location is a characteristic of the asset -> altered by a change in location (transport)
- Characteristics of assets/liabilities to be considered when pricing (#BC 48)

Transaction cost: not considered

- Arise from the transaction and do not change the characteristic of the asset (#16)

Recent status of discussions at the GASB

- Transaction costs are part of any potential buyer's consideration and therefore would influence the market price.
- When using the exit price concept the related transaction costs should also be reflected in the measurement in order to appropriately determine the complete expected inflows or outflows of economic benefits; otherwise the hypothetical concept is not seen as consistently applied.

Your comments?



Other issues: Blockage factors

- No consideration when measuring fair value because:
- (a) IAS 39: Unit of account is the individual instrument
- (b) An entity's decision to sell at a less advantageous price because it sells its entire holding rather than each instrument individually is a factor specific to that entity. (#BC 35)

Recent status of discussions at the GASB

- Many situations existing in which disregarding blockage factors would be inappropriate, (acquisition of a 90% stake of an entity in a business combination)

Reference Market?

Market for controlling interests

or

Market for single shares

- Two different markets -> participants are mostly not the same.

Your comments?



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