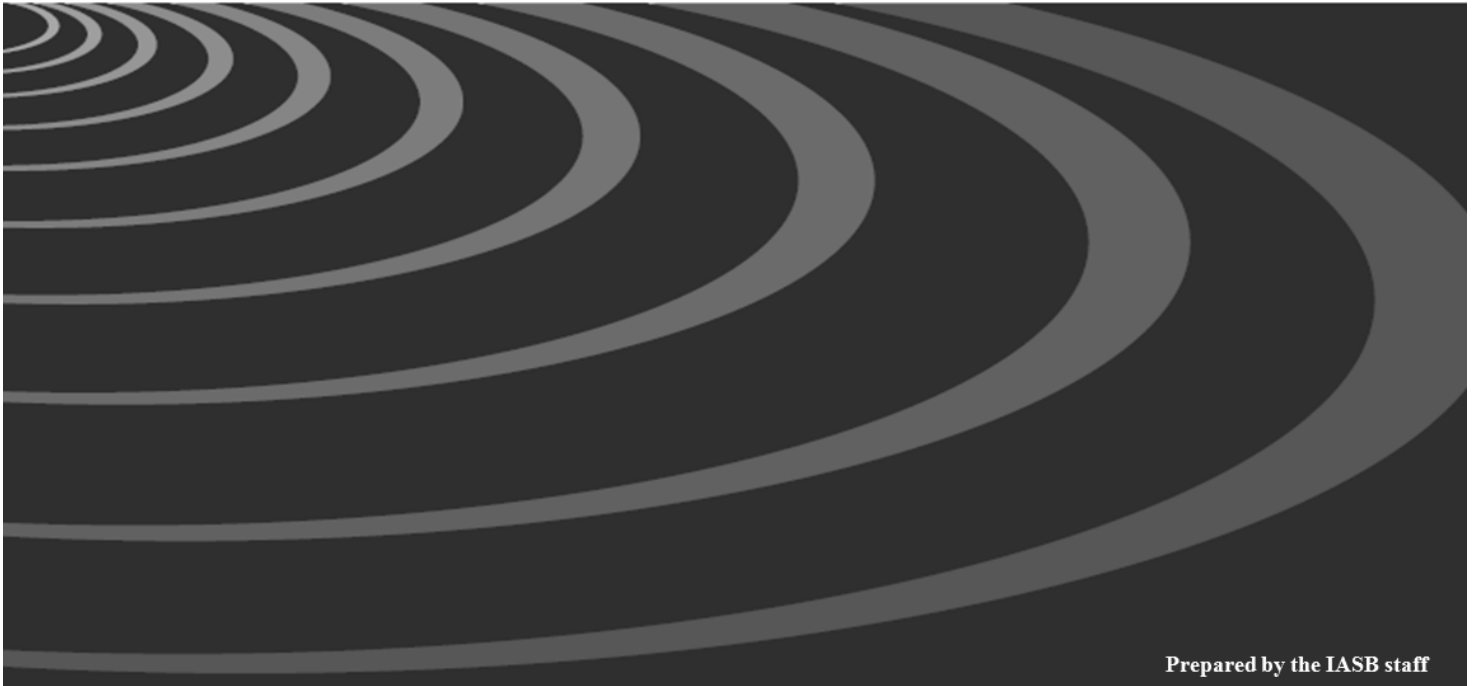


July 2010

Comprehensive Project Summary

Developing common fair value measurement and disclosure requirements in IFRSs and US GAAP



Prepared by the IASB staff

IFRSs together with their accompanying documents are issued by the International Accounting Standards Board (IASB),

30 Cannon Street, London, EC4M 6XH, United Kingdom

Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411

Email: ifrs@ifrs.org Web: www.ifrs.org

Copyright © 2010 IFRS Foundation

International Financial Reporting Standards, International Accounting Standards, Interpretations, exposure drafts, and other publications by the IASB are copyright of the IFRS Foundation. The approved text of International Financial Reporting Standards, International Accounting Standards and Interpretations is that issued by the IASB in the English language. Copies may be obtained from the IFRS Foundation Publications Department. Please address publication and copyright matters to:

IFRS Foundation Publications Department

30 Cannon Street, London, EC4M 6XH, United Kingdom.

Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749

Email: publications@ifrs.org Web: www.ifrs.org

All rights reserved. No part of this publication may be translated, reprinted, reproduced, distributed or utilised in any form either in whole or in part or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage and retrieval system, without prior permission in writing from the IFRS Foundation.



Table of contents

At a glance	2
Overview	2
Next steps	3
<hr/>	
Why the IASB is undertaking this project	5
Defining fair value and providing a clear fair value measurement framework	6
Enhancing disclosures about fair value measurements	6
<hr/>	
Project history	7
Background	7
The financial crisis	7
Outreach activities	8
Convergence of IFRSs and US GAAP	9
<hr/>	
Comparison with ED/2009/5 and the FASB's exposure draft	11
Definition of fair value	12
The transaction	14
Measuring the fair value of liabilities	16
Applying valuation adjustments in a fair value measurement	18
Measuring the fair value of financial instruments that are managed within a portfolio	20
Application of blockage factors and other premiums and discounts	25
Terminology to describe the valuation premise	29
Measurement uncertainty analysis disclosure	30
How would an IFRS compare with US GAAP?	32
<hr/>	
Resources	36

At a glance

This comprehensive project summary, prepared by the International Accounting Standards Board (IASB) staff, provides the background of the IASB's fair value measurement project and explains how the IASB plans to finalise an IFRS on fair value measurement.

This project summary also compares the tentative decisions reached so far in the project with:

- the proposals in the IASB's May 2009 exposure draft *Fair Value Measurement* (ED/2009/5); and
- the proposals in the US Financial Accounting Standards Board's (FASB) exposure draft of a proposed Accounting Standards Update (ASU) *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, which proposes amendments to Topic 820 *Fair Value Measurements and Disclosures* in the FASB Accounting Standards CodificationTM (which codified FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157)).

Overview

In March 2010 the IASB completed its initial discussions with the FASB to develop common requirements for measuring fair value and for disclosing information about fair value measurements. Those discussions have resulted in the FASB proposing amendments to Topic 820 and the IASB publishing an exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* (ED/2010/7). ED/2010/7 is a limited re-exposure of a proposed disclosure in ED/2009/5.

The result of the IASB's discussions with the FASB will be an International Financial Reporting Standard (IFRS) on fair value measurement that is almost the same as Topic 820, as amended (the differences are summarised on page 32). That forthcoming IFRS would apply when other IFRSs require or permit fair value measurements or disclosures. It would not introduce new fair value measurements, nor would it eliminate practicability exceptions to fair value measurements (eg the exception in IAS 41 *Agriculture* when an

entity is unable to measure reliably the fair value of a biological asset on initial recognition). In other words, the forthcoming IFRS would specify *how* an entity should measure fair value and disclose fair value information. The IFRS would not specify *when* an entity should measure an asset, a liability or its own equity instrument at fair value.

Before publishing ED/2010/7 in June 2010, the IASB considered whether there was a need to re-expose ED/2009/5 in its entirety because of the tentative decisions reached in the Board’s subsequent deliberations. In making that determination, the Board considered whether those tentative decisions were consistent either with the proposals in ED/2009/5 or with current requirements in IFRSs.

The Board concluded that the proposed requirement to take into account the effect of correlation in the measurement uncertainty analysis needed to be exposed because that requirement was not proposed in ED/2009/5 and is not currently required in IFRSs. The Board concluded that the other tentative decisions reached in this project are consistent either with the proposals in ED/2009/5 or with current requirements in IFRSs. Therefore, the Board determined that it was unnecessary to re-expose what had already been exposed or what would maintain existing requirements.

Next steps



Finalising an IFRS on fair value measurement

The result of this project will be an IFRS on fair value measurement, which the Board expects to issue during the first quarter of 2011. The boards' objective is to ensure that the fair value measurement and disclosure requirements in the forthcoming IFRS and the FASB's fair value measurement standard, Topic 820 (as amended), would be the same (except for minor differences in wording and style).

The boards' discussions about fair value measurement are not yet complete. The boards will jointly consider the responses to their respective exposure drafts after the exposure periods end on 7 September 2010.

It is not necessary to submit letters commenting on the proposals in the exposure drafts to both the IASB and the FASB. The FASB will accept comment letters from IFRS constituents on the proposals in its exposure draft of proposed amendments to Topic 820.

Developing educational material

To help those applying the forthcoming fair value measurement guidance, particularly in emerging and transition economies, the IASB staff is developing educational material to accompany an IFRS on fair value measurement. That educational material will describe at a high level the thought process for measuring assets, liabilities or an entity's own equity instruments at fair value consistent with the objective of a fair value measurement. The IASB staff and the FASB staff will liaise during the development of the material. The educational material will be published shortly after the Board issues an IFRS on fair value measurement.

Why the IASB is undertaking this project

Several IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or its own equity instruments. However, the fair value measurement guidance is dispersed among the IFRSs that refer to fair value and many of those IFRSs do not articulate a clear measurement objective. As a result, some IFRSs contain limited measurement guidance, whereas others contain extensive guidance and that guidance is not always consistent. Inconsistencies in that guidance have added to the complexity of financial reporting and have contributed to diversity in practice.

The forthcoming IFRS on fair value measurement would be a single source of fair value measurement guidance that would clarify the definition of fair value, provide a clear framework for measuring fair value and enhance the disclosures about fair value measurements. Once the boards complete their discussions, the fair value measurement and disclosure requirements in IFRSs and US generally accepted accounting principles (GAAP) would be almost identical. The remaining differences would include the following (see page 32):

- the documents would have different scope exceptions because different assets, liabilities and equity instruments are measured at fair value in IFRSs and US GAAP;
- there will be different accounting requirements in IFRSs and US GAAP for measuring the fair value of investments in investment company entities;
- there will be different disclosure requirements (eg distinguishing between ‘recurring’ and ‘non-recurring’ fair value measurements); and
- there will be minor differences in wording and style (eg spelling).

Defining fair value and providing a clear fair value measurement framework

The fair value measurement framework would be based on a core principle that defines fair value as an exit price, as follows:

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.

That definition retains the exchange price notion contained in the existing definition of fair value in IFRSs:

The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Like the existing definition of fair value in IFRSs, the proposed definition assumes that the exchange transaction is hypothetical and is orderly (ie it is not a forced liquidation or distress sale). However, the existing definition of fair value:

- does not specify whether an entity is buying or selling the asset;
- is unclear about what is meant by 'settling' a liability because it does not refer to the creditor, but to knowledgeable, willing parties; and
- does not explicitly state whether the exchange or settlement takes place at the measurement date or at some other date.

In the Board's view, the proposed definition of fair value remedies these deficiencies. It also conveys more clearly that fair value assumes an orderly transaction between market participants, and thus is a market-based measurement, not an entity-specific measurement.

Enhancing disclosures about fair value measurements

The proposed disclosures would increase transparency about fair value measurements, including the valuation techniques and inputs used to measure fair value. The Board believes this increased transparency would benefit users of financial statements, particularly when assessing the fair value measurements of assets and liabilities without active markets.

Project history

Background

In September 2005 the IASB added to its agenda a project to clarify the meaning of fair value and to provide guidance for its application in IFRSs. The first step in the process was to publish a discussion paper summarising the Board's preliminary views about fair value measurement. At the time the fair value measurement project was added to the IASB's agenda, the FASB was already well advanced in the development of its own fair value measurement standard, which was published in September 2006. Although at the time the IASB worked separately from the FASB, the goal for both boards was to have common fair value measurement guidance at a future date.

Because of the consistency of SFAS 157 with much of the fair value measurement guidance in IFRSs and the need for increased convergence of IFRSs and US GAAP, the IASB used the FASB's fair value measurement standard (SFAS 157 at the time) as a basis for the Board's preliminary views in the discussion paper. The Board received 136 comment letters on that discussion paper and began its deliberations for the development of ED/2009/5 in November 2007. The Board published ED/2009/5 in May 2009, with a four-month comment period. The Board received 160 comment letters in response to the proposals in that exposure draft.

The financial crisis

The advent of the financial crisis emphasised the importance of having common fair value measurement guidance in IFRSs and US GAAP, particularly for measuring fair value when the market activity for an asset or a liability declines. As a result, and in line with the recommendations of the Group of Twenty Finance Ministers and Central Bank Governors (G20) finance ministers, the Financial Stability Board and the Financial Crisis Advisory Group, the IASB and the FASB enhanced their joint efforts to develop common fair value measurement guidance.

In May 2008 the IASB set up a Fair Value Expert Advisory Panel in response to recommendations made by the Financial Stability Forum (now the Financial Stability Board) to address the measurement and disclosure of financial instruments when markets are no longer active. The IASB staff published a staff report on the Panel's findings in October 2008. The Panel's report *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* is available on the IASB's website.

Also in response to the financial crisis, the FASB issued FASB Staff Position No. FAS 157-4 *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability has Significantly Decreased and Identifying Transactions that are Not Orderly* (FSP) in April 2009. That FSP provides guidance for:

- measuring fair value when the volume and level of activity for the asset or liability have significantly decreased; and
- identifying circumstances that indicate a transaction is not orderly.

The Board published a *Request for Views* that asked respondents whether they believed the guidance in that FSP was consistent with the Panel's report. The Board also asked the Expert Advisory Panel the same question. The Board received 69 responses to the *Request for Views*. The respondents to the *Request for Views* and the Expert Advisory Panel indicated that the FSP was consistent with the Panel's report. As a result, the Board included the guidance from that FSP in ED/2009/5.

As a result of the financial crisis, there was a particularly urgent need to improve transparency of fair value measurements for financial instruments. To address this need, the Board amended the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*. Those amendments also increased the convergence of IFRSs and US GAAP.

Outreach activities

The IASB's public consultations on fair value measurement have been extensive and have spanned several years. The letters the Board received commenting on the discussion paper and on ED/2009/5 have not been the only sources of feedback. As well as taking part in the round-table meetings held in 2009, the staff and Board members attended and gave presentations at numerous seminars and met with representatives of many organisations and constituencies internationally. The outreach activities are ongoing.

Although discussion papers and exposure drafts are the most significant part of the IASB's process of public consultation, the consultations on this project began much earlier. By the time the Board published ED/2009/5, it had debated the proposals at several public Board meetings. The Board also held meetings with the IFRS Advisory Council and with industry groups and other interested parties (including the Fair Value Expert Advisory Panel) to benefit from their insight and expertise on specific issues, including industry-related questions. The Board also considered valuation issues raised by members of the FASB's Valuation Resource Group. That group comprises accounting, auditing, analyst, valuation and related financial reporting experts in business combinations and other accounting situations.

Convergence of IFRSs and US GAAP

Because the proposals in ED/2009/5 were developed on the basis of the requirements in SFAS 157 (now Topic 820), there were many similarities. However, some of those proposals were different and the proposals in ED/2009/5 used wording that was similar, but not identical, to the wording in Topic 820. As a result, respondents to ED/2009/5 asked the IASB to work with the FASB to develop common fair value measurement and disclosure requirements in IFRSs and US GAAP.

In response to that request, the IASB and the FASB agreed at their joint meeting in October 2009 to work together to achieve that goal. To do that, the boards would need to ensure that fair value has the same meaning in IFRSs and in US GAAP and that the fair value measurement and disclosure requirements would be the same (except for minor differences in wording and style).

The boards believe that having common fair value measurement and disclosure requirements would improve the comparability of financial statements prepared in accordance with IFRSs and US GAAP. In addition, the boards expect that having common requirements would reduce diversity in the application of fair value measurement guidance and simplify financial reporting. As a result, the FASB agreed to consider comments received on ED/2009/5 and to propose amendments to US GAAP to achieve that goal. The FASB's exposure draft of proposed amendments to Topic 820 is a result of those efforts.

The boards' joint discussions began in January 2010. The boards discussed nearly all of the issues together so that each of the boards could benefit from hearing the rationale for the other board's decisions on each issue. Those discussions focused on the following:

- the differences between the proposals in ED/2009/5 and the requirements in Topic 820;
- the comments received on the proposals in ED/2009/5;
- the feedback received about the implementation of Topic 820 (eg issues discussed by the FASB's Valuation Resource Group); and
- the feedback received from participants in the IASB's round-table meetings, which were attended by representatives of over 50 leading organisations from around the world, held in November and December 2009 in Norwalk, Connecticut USA; Tokyo, Japan; and London, United Kingdom.

The boards completed their initial discussions in March 2010. They will resume their discussions after the exposure periods of their respective exposure drafts end.

Comparison with ED/2009/5 and the FASB's exposure draft

In their joint discussions, the IASB and the FASB considered the matters raised in the letters commenting on the proposals in ED/2009/5 along with matters raised through other consultations. As a result, some of the tentative decisions reached are different from those proposed in ED/2009/5.

The most prevalent comment received was that the IASB and the FASB should work together to resolve any differences between the proposals in ED/2009/5 and the current requirements in US GAAP (Topic 820). As a result of that feedback, this became a joint project with the FASB in October 2009. The FASB agreed to consider the comments received on ED/2009/5 and to propose amendments to Topic 820, if necessary. Those proposed amendments, which would result in common fair value measurement and disclosure requirements in IFRSs and US GAAP, are available on the FASB website.

The tentative decisions reached so far in the fair value measurement project (which formed the basis for the FASB's proposed amendments to Topic 820) are subject to change pending the IASB's continuing discussions with the FASB after the exposure periods of their respective exposure drafts end. A summary of the tentative decisions reached is available on the IASB's and the FASB's websites.

The comments received from respondents clearly indicated that many viewed the proposals in ED/2009/5 as a change to current practice even though the Board believed that the most significant change would be to move the fair value measurement guidance from individual IFRSs to a single IFRS on fair value measurement. The Board believed that only minimal changes were needed in the measurement guidance itself. Rather, the changes in the measurement guidance were made to clarify the measurement objective and to improve consistency in application.

Furthermore, some respondents welcomed the additional guidance the IASB proposed for measuring fair value, particularly the guidance for measuring fair value when markets have become less active.

The sections that follow provide a more detailed explanation of the matters raised by respondents to the proposals in ED/2009/5 and how the boards' thinking was influenced in reaching their tentative decisions.

Definition of fair value

ED/2009/5 proposed defining fair value as 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 (an exit price). This is the definition of fair value in Topic 820.

What people said

The definition of fair value in and of itself is not a controversial issue. Many respondents thought the proposal to define fair value as a market-based exit price was appropriate because it would retain the notion of an exchange between unrelated, knowledgeable and willing parties in the current definition of fair value in IFRSs, but it would provide a clearer measurement objective. Other respondents thought an entry price would be more appropriate in some situations (eg at initial recognition).

The issue of when fair value should be used as a measurement basis in IFRSs is controversial. There is disagreement about (a) which assets and liabilities could appropriately be measured at fair value (eg a financial asset with a quoted price in an active market and that the entity intends to sell in the near term) and (b) when those assets and liabilities should be measured at fair value (eg whether the measurement basis should change when markets have become less active).

The response to that feedback

Determining when fair value should be used as a measurement basis for a particular asset or liability or revisiting when fair value has been used in IFRSs is outside the scope of the fair value measurement project.

When developing the proposals in ED/2009/5, the IASB assessed each IFRS that requires or permits fair value measurements to determine whether a particular use of fair value should be within the scope of an IFRS on fair value measurement. In making that assessment, the IASB considered whether each use of fair value in IFRSs was consistent with an entry price or an exit price and whether the measurement guidance in each IFRS was consistent with the measurement guidance being developed in the fair value measurement project.

That assessment resulted in a decision to exclude share-based payment transactions within the scope of IFRS 2 *Share-based Payment* and leasing transactions within the scope of IAS 17 *Leases* from the scope of a forthcoming IFRS on fair value measurement.

Tentative conclusion—retain the proposal

Given that the focus of the fair value measurement project is to clarify the measurement objective, the boards agreed to define fair value as an exit price. This is consistent with the definition of fair value proposed in ED/2009/5 and the definition in US GAAP.

The transaction

ED/2009/5 proposed that the transaction to sell an asset or transfer a liability takes place in the most advantageous market to which the entity has access. That proposal contained a presumption that the market in which the entity normally enters into a transaction for the asset or liability is the most advantageous market and that an entity may assume that the principal market for the asset or a liability is the most advantageous market.

This is different from the approach in Topic 820, which referred to the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.

What people said

Many respondents agreed with the most advantageous market notion because most entities enter into transactions that maximise the price received to sell an asset or minimise the price paid to discharge a liability. Furthermore, a most advantageous market notion works best for all assets and liabilities, regardless of the level of activity in a market or whether the market for an asset or liability is observable.

However, some respondents were concerned about the difficulty with identifying and selecting the most advantageous market when an asset or liability is exchanged in multiple markets throughout the world. Other respondents found the guidance confusing because it was not clear whether the most advantageous market must be used or how the market in which the entity normally enters into transactions relates to the principal market or to the most advantageous market. In general, respondents preferred the approach in Topic 820.

The response to that feedback

Although the boards think that in most cases the principal market and the most advantageous market would be the same, they agreed that the focus should be on the principal market for the asset or liability. The principal market is the market with the greatest volume and level of activity for the asset or liability. The boards agreed that the principal market would provide the most representative input for a fair value measurement because that market is the most liquid market for the asset or liability.

The boards also agreed that, in the absence of an observable market, an entity should consider the characteristics of market participants who would enter into a transaction for the asset or liability. This is because a market does not need to be observable to exist, although it would be difficult to conceptualise the principal market for assets and liabilities categorised within Level 3 of the fair value hierarchy because there would be no basis by which an entity can determine the volume or level of activity for the asset or liability.

Tentative conclusion—a change in focus

Given the feedback received and the need to develop common fair value measurement guidance, the boards agreed that a fair value measurement assumes that the transaction to sell an asset or to transfer a liability takes place in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.

In addition, there is a presumption that the principal market is the market in which an entity normally enters into a transaction for the asset or liability.

Measuring the fair value of liabilities

ED/2009/5 proposed the following with respect to liabilities:

- An entity can estimate the amount at which a liability could be transferred in a transaction between market participants by using the same methodology that would be used to measure the fair value of the liability held by another entity as an asset (ie the fair value of the corresponding asset). If the liability is traded as an asset, the observed price also represents the fair value of the issuer's liability. If there is no corresponding asset, the fair value of the liability could be measured using a valuation technique, such as the present value of the future cash outflows that market participants would expect to incur in fulfilling the obligation.
- The fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation. Non-performance includes, but is not limited to, an entity's own credit risk.
- A restriction on an entity's ability to transfer its liability to another party does not affect the fair value of the liability because the fair value of a liability is a function of the requirement to fulfil the obligation and the effect of a restriction is already reflected in the price.

This is consistent with the approach in Topic 820 (Topic 820 was amended to provide additional guidance about measuring the fair value of liabilities after ED/2009/5 was published). However, Topic 820 provides more guidance than what was in the IASB's exposure draft, including additional examples for applying that guidance.

What people said

The proposals to define the fair value of a liability as a transfer price and to include the effect of non-performance risk are controversial. Those concerns are mainly about whether fair value is an appropriate measurement basis for some liabilities (eg those liabilities that can be transferred).

In addition, respondents generally found the guidance about using the fair value of the corresponding asset or a fulfilment amount to measure the fair value of a liability helpful, particularly because that is typically how they think about the value of a liability. Many of the participants at the IASB's round-table meetings in the US said they had found the additional guidance in Topic 820 useful.

The response to that feedback

Because the guidance in Topic 820 is consistent with the proposals in ED/2009/5, the boards worked together to develop a combination of the two.

Tentative conclusion—provide more guidance

The boards agreed that in the absence of a quoted price in an active market to transfer the identical liability, an entity would measure the fair value of the liability as follows:

- using the quoted price in an active market for the identical liability held by another entity as an asset, if that price is available.
- 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.
- if observable inputs are not available, using another valuation technique such as an income approach (eg a present value technique) or a market approach (eg using the amount that a market participant would pay to transfer the identical liability or receive to enter into the identical liability).

The boards also agreed that the fair value of a liability:

- reflects the effect of non-performance risk and
- should not be adjusted further for the effect of a restriction on its transfer if that restriction is already included in the other inputs to the fair value measurement.

This is consistent with the approach proposed in ED/2009/5 and the current requirements in Topic 820.

Applying valuation adjustments in a fair value measurement

Although ED/2009/5 did not explicitly address valuation adjustments (including risk adjustments related to the uncertainty inherent in the inputs used in a fair value measurement), it did state that an entity must use the assumptions market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique or in the inputs to the valuation technique. This implicitly includes measurement uncertainty.

This is consistent with the current requirements in Topic 820.

What people said

Respondents asked for explicit guidance for applying valuation adjustments in a fair value measurement. They found the descriptions of valuation adjustments in the IASB's Fair Value Expert Advisory Panel report helpful. In addition, regulators asked the Board to address measurement uncertainty to ensure that fair value measurements are not overstated or understated in the statement of financial position, thus improving the quality of information available to users of financial statements.

The response to that feedback

The discussion in the Expert Advisory Panel's report has been helpful to entities measuring the fair value of financial instruments during a period of market inactivity. As a result, the boards agreed to include the practices for applying valuation adjustments described in that report in their respective fair value measurement standards.

Tentative conclusion—provide more guidance

The boards agreed to describe the valuation adjustments that entities might need to make when using a valuation technique because market participants would make those adjustments when pricing a financial asset or financial liability under the market conditions at the measurement date, including adjustments for measurement uncertainty.

Those valuation adjustments include the following:

- an adjustment to a valuation technique to take into account a characteristic of an asset or a liability that is not captured by the valuation technique (the need for such an adjustment is typically identified during calibration of the value calculated using the valuation technique with observable market information);
- applying the point within the bid-ask spread that is most representative of fair value in the circumstances;
- an adjustment to take into account non-performance risk (eg an entity's own credit risk or the credit risk of the counterparty to a transaction); and
- an adjustment to take into account measurement uncertainty (eg when there has been a significant decrease in the volume and level of activity when compared with normal market activity for the asset or liability [or similar assets or liabilities] and the entity has determined that the transaction price or quoted price does not represent fair value).

The boards agreed that it would be appropriate to apply such valuation adjustments if those adjustments are consistent with the objective of a fair value measurement.

Valuation adjustments may help avoid an understatement or an overstatement of a fair value measurement and should be applied when a valuation technique or the inputs to a valuation technique do not capture factors that market participants would take into account when pricing an asset or a liability at the measurement date, including assumptions about risk.

Measuring the fair value of financial instruments that are managed within a portfolio

ED/2009/5 proposed that the ‘in-exchange’ valuation premise must be used to measure the fair value of financial assets. The Board also proposed an amendment to IAS 39 *Financial Instruments: Recognition and Measurement* specifying that the unit of account for a financial instrument is the individual financial instrument at all levels of the fair value hierarchy (ie Levels 1, 2 or 3). The Board concluded that the fair value of a financial asset reflects any benefits that market participants would derive from holding that asset within a diversified portfolio. Therefore, an entity would derive no incremental value from holding the asset within a portfolio.

In US GAAP, many entities currently apply the in-use valuation premise when measuring the fair value of financial assets and financial liabilities. That is, an entity takes into account how the fair value of each financial asset or financial liability might be affected by the combination of that asset or liability with other financial assets or financial liabilities held by the entity. Other entities apply the in-exchange valuation premise to the entity’s net exposure to market risks (ie interest rate risk, currency risk or other price risk) or to the credit risk of each of the counterparties and assume that the transaction is for the net position, not for the individual assets and liabilities comprising that position. Those differing applications of the valuation premise arose because Topic 820 does not specify the valuation premise for financial assets.

What people said

The proposal to require the fair value of a financial asset to be measured using the in-exchange valuation premise is one of the most controversial proposals in ED/2009/5. That proposal, combined with the proposed amendment to IAS 39 about the unit of account for financial instruments, led respondents to believe that the fair value of financial assets cannot reflect the fact that those assets are held within a portfolio, even when an entity manages its financial instruments on the basis of the entity’s net exposure, rather than its gross exposure, to market risks and credit risk.

Respondents were concerned that the proposal in ED/2009/5 would separate the valuation of financial instruments for financial reporting from the entity’s internal risk management practices. In addition, they were concerned about the systems changes that would be necessary to effect a change in practice.

To preserve the relationship between financial reporting and risk management, some respondents asked whether they would be able to apply the proposed bid-ask spread guidance to each of the individual instruments so that the sum of the fair values of the individual instruments equals the value of the net position.

Other respondents suggested that the IASB should continue to allow the practice that has developed by using paragraph AG72 of IAS 39, which states that ‘when an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate’.

As with other aspects of the proposals in ED/2009/5, respondents asked the IASB and the FASB to work together to ensure that IFRSs and US GAAP have the same requirements for measuring the fair value of financial instruments.

The response to that feedback

Entities that apply IFRSs or US GAAP currently reach similar fair value measurement conclusions in many cases when measuring the fair value of financial assets and financial liabilities that are managed on the basis of the entity’s net exposure to a particular market risk (or risks) and to the credit risk of a particular counterparty. However, the guidance in IFRSs and US GAAP for measuring the fair value of financial instruments is articulated differently. The boards believe it is important that IFRSs and US GAAP have the same requirements for measuring the fair value of financial instruments.

Tentative conclusion—permit an exception

The boards believe that the accounting for financial instruments should provide information about the risks inherent in financial instruments on the basis of how an entity manages its business so that users of financial statements can assess the amounts, timing and uncertainty of future cash flows.

Consequently, the guidance for measuring the fair value of financial instruments, including those that are managed on the basis of an entity’s net risk exposure, needs to reflect the relationship between an entity’s business strategy and the fair value measurement of financial instruments managed in that way.

The current guidance for measuring the fair value of financial instruments in IFRSs and US GAAP does not explicitly address how the following meet the objective of a fair value measurement for financial instruments:

- Entities typically do not manage their exposure to market risks and credit risk by selling a financial asset or transferring a financial liability (eg by unwinding a transaction). Rather, they manage their risk exposure by entering into a transaction for another financial instrument (or instruments) that would result in an offsetting position in the same risk.
- The resulting measurement represents the fair value of the net risk exposure, not of an individual financial instrument. The sum of the fair values of the individual instruments is not equal to the fair value of the net risk exposure.
- An entity's net risk exposure is a function of the other financial instruments held by the entity and of the entity's risk preferences (both of which are entity-specific decisions and, thus, do not form part of a fair value measurement). Market participants might hold different groups of financial instruments or might have different risk preferences, and it is those factors that are taken into account when measuring fair value. However, the boards understand that market participants holding that particular group of financial instruments and with those particular risk preferences would be likely to price those financial instruments in the same way (ie using the same valuation techniques and the same market data). As a result, the measurement of those financial instruments within that particular group is a market-based measurement.

As a result, the boards agreed to permit an exception to the requirements for measuring fair value when an entity manages its financial assets and financial liabilities on the basis of the entity's net exposure to market risks or counterparty credit risk. That exception would permit an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (ie an asset) for a particular risk exposure or to transfer a net short position (ie a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date.

The boards agreed to specify that to be able to use that exception, an entity would need to provide evidence that it manages its financial instruments on the basis of the entity's net exposure to those risks on a consistent basis. Evidence that the entity is managing its financial instruments in that way would include having a documented risk management or investment strategy describing the management of financial instruments within the organisation and providing information about the net risk exposure to management. Furthermore, the boards agreed to specify that the entity must be required (or must have elected) to measure the financial instruments at fair value in the statement of financial position.

In addition, the boards agreed to specify that the market risks that are being offset must be substantially the same for an entity to be able to use that exception. The boards concluded that an entity should be permitted to apply the bid-ask spread guidance to the entity's net position in a particular market risk (rather than to each individual financial instrument comprising that position) when the market risks that are being offset are substantially the same. For example, an entity would be able to apply that exception when it uses that group of financial instruments to identify and manage its exposure to a particular type of interest rate risk alone, not when the entity uses that group of financial instruments to manage all market risks to which the entity is exposed.

The boards also agreed to specify that the entity would be able to consider its net exposure to counterparty credit risk only when there is a legally enforceable right of offset (eg a master netting agreement) with the counterparty in the event of default. Without a legally enforceable right of offset, the boards believe that market participants would take into account the gross exposure, rather than the net exposure, to the credit risk of a particular counterparty when measuring fair value.

The boards note that the group of financial assets and financial liabilities for which an entity manages its net exposure to a particular market risk (or risks) might differ from the group of financial assets and financial liabilities for which an entity manages its net exposure to the credit risk of a particular counterparty.

In addition, the boards agreed that:

- the exception would also apply to derivatives that an entity is required or has elected to measure at fair value in accordance with IAS 39 or IFRS 9 *Financial Instruments* (or the relevant Topics in US GAAP);
- an entity would need to comply with the financial statement presentation requirements specified in other IFRSs (or other Topics in US GAAP) (ie the exception would not apply to financial statement presentation);
- if there is a quoted price in an active market (ie a Level 1 input) for a financial asset or a financial liability within the group of financial assets and financial liabilities, an entity would need to use that quoted price without adjustment when measuring fair value; and
- an entity would be able to use mid-market pricing or another pricing convention as a practical expedient when applying the exception.

Application of blockage factors and other premiums and discounts

Some entities hold a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments. ED/2009/5 did not explicitly address the application of an adjustment to the quoted price of an asset or a liability because of the size of an entity's position relative to trading volume (commonly referred to as a 'blockage factor'). However, ED/2009/5 proposed amending IAS 39 to specify that the unit of account for a financial instrument is the individual financial instrument at all levels of the fair value hierarchy. That proposal effectively would prohibit the application of blockage factors and other premiums and discounts in a fair value measurement categorised within any level of the fair value hierarchy for financial instruments within the scope of IAS 39.

The Board proposed that guidance for the following reasons:

- the unit of account for a financial instrument should not change because of the instrument's categorisation within the fair value hierarchy; and
- market participants will enter into a transaction to sell a financial instrument at the most advantageous price for the instrument. An entity's decision to sell at a less advantageous price because it sells an entire holding rather than each instrument individually is a factor specific to that entity.

That proposal was consistent with Topic 820 for fair value measurements categorised within Level 1 of the fair value hierarchy. Topic 820 generally prohibits any adjustment to a quoted price in an active market for an identical asset or liability (including a blockage factor or other premiums or discounts) for a fair value measurement categorised within Level 1 of the fair value hierarchy. However, Topic 820 does not specify whether a blockage factor (or another premium or discount, such as a control premium or a non-controlling interest discount), can be applied in a fair value measurement categorised within Level 2 or Level 3 of the fair value hierarchy.

What people said

Most respondents to ED/2009/5 did not support that proposal because, in their view, entities do not typically exit a position on an individual instrument basis (eg entering into a transaction to sell a single ordinary share). As a result, they believe the fair value measurement should reflect the fair value of the *holding*, not of each individual instrument comprising the holding (ie they do not agree that the unit of account for a financial instrument should be the individual instrument). The FASB received similar comments when SFAS 157 was issued.

In addition, respondents seemed to have different interpretations about what the term ‘blockage factor’ means. For example, some respondents thought the Board intended to prohibit the application of a premium or discount (such as a control premium) even when market participants would take into account a premium or discount when pricing the asset or liability for that unit of account (eg a controlled investment accounted for in accordance with IAS 27 *Consolidated and Separate Financial Statements*).

The response to that feedback

The boards concluded that it would be necessary to clarify what a blockage factor is and to specify whether and, if so, when a blockage factor or another premium or discount should be taken into account in a fair value measurement.

Tentative conclusion—clarify the proposal

The boards agreed to use the current description of a blockage factor in Topic 820 because they concluded that it accurately describes what a blockage factor is. Topic 820 states that a blockage factor is an adjustment to a quoted price for an asset or a liability when the normal daily trading volume for the asset or liability is not sufficient to absorb the quantity held and placing orders to sell the asset or liability in a single transaction might affect the quoted price. Blockage factors are most commonly observed in transactions for financial instruments, such as equity or debt securities.

However, the boards acknowledged that Topic 820 does not distinguish between a blockage factor and other premiums and discounts, nor does it describe those other premiums or discounts (with the exception of an adjustment for liquidity risk, which is described in the guidance for measuring the fair value of an asset or a liability in an inactive market). The IASB noted that other IFRSs, such as IFRS 3 *Business Combinations*, refer to the application of control premiums and non-controlling interest discounts.

The boards agreed to use the principle underlying a fair value measurement (ie a fair value measurement takes into account the characteristics of the asset or liability that market participants would take into account when pricing the asset or liability given the unit of account specified in another IFRS) when describing the application of other premiums and discounts in a fair value measurement. Therefore, the boards agreed to specify that an entity would apply a premium or discount in a fair value measurement if market participants would take into account such a premium or discount when pricing the asset or liability given the unit of account specified in another IFRS (eg a market participant is likely to consider a control premium when pricing a cash-generating unit). The boards agreed not to provide detailed descriptions of other premiums and discounts or to provide detailed guidance about their application in a fair value measurement. The boards concluded that such descriptions and guidance would be too prescriptive and that the application of such premiums and discounts depends on the facts and circumstances.

Given the description of a blockage factor, the boards concluded that an entity's decision to incur a blockage factor is specific to that entity, not to the asset or liability. Furthermore, a blockage factor is observed when the quantity held is greater than the normal daily trading volume for the asset or liability. In many cases, the unit of account for a financial instrument is the individual financial instrument. In such cases, the size of an entity's holding is not relevant. An entity would only incur a blockage factor when that entity decides to enter into a transaction to sell a block comprising a large number of identical assets or liabilities. In that way, blockage factors are like transaction costs and will differ depending on how an entity enters into a transaction for an asset or a liability. The boards believe that if an entity decides to enter into a transaction to sell a block, the consequences of that decision should be reported when the decision is carried out. This is consistent with the FASB's rationale in developing SFAS 157.

Because the decision to incur a blockage factor is specific to the entity, the boards agreed to prohibit its application, even when an entity expects to incur a blockage factor upon the sale of an asset or a liability. The boards concluded that a blockage factor could arise only when fair value is measured using a quoted price for the asset or liability (or similar assets or liabilities). As a result, the boards concluded that a blockage factor would not be relevant when fair value is measured using a valuation technique that does not use a quoted price for the asset or liability (or similar assets or liabilities).

In addition, the boards agreed to specify that fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy would take into account other premiums or discounts that market participants would take into account when pricing an asset or a liability given the unit of account specified in another IFRS (eg a non-controlling interest discount). The boards concluded that a fair value measurement would take into account those premiums or discounts that represent a characteristic of the asset or liability that would transfer to a market participant.

Terminology to describe the valuation premise

ED/2009/5 and Topic 820 both use the terms ‘in use’ and ‘in exchange’ to describe the valuation premise for a fair value measurement. The ‘in-use’ valuation premise assumes that an asset would be used in combination with other assets or with other assets and liabilities and that those assets and liabilities (ie its complementary assets and liabilities) would be available to market participants (ie its value is maximised when it is used in combination with other assets and liabilities). The ‘in-exchange’ valuation premise assumes that an asset would be used on a stand-alone basis (ie its value is maximised when it is used on its own).

What people said

Some respondents suggested replacing the terms ‘in use’ and ‘in exchange’ with other terms because they thought the terminology did not accurately reflect the objective of the valuation premise. For example, in a literal reading, ‘in use’ implies that the asset is being used in the entity’s operations and ‘in exchange’ implies that the asset is being sold. In fact, both ‘in use’ and ‘in exchange’ represent exchange transactions (ie the asset is being sold) and both reflect the asset’s use in the entity’s operations (ie ‘in use’ assumes that the asset would be *used* in combination with other assets or with other assets and liabilities and ‘in exchange’ assumes that the asset would be *used* on a stand-alone basis).

In addition, some thought that the ‘in-use’ valuation premise could be confused with ‘value in use’ in IAS 36 *Impairment of Assets*.

The response to that feedback

It was clear from the comments received that the terminology used to refer to the valuation premise is confusing.

Tentative conclusion—remove the terms altogether

The boards agreed to remove those terms altogether and instead describe the objective of the valuation premise. The valuation premise would assume that an asset is used either (a) in combination with other assets or with other assets and liabilities or (b) on a stand-alone basis.

Measurement uncertainty analysis disclosure

ED/2009/5 proposed a measurement uncertainty analysis disclosure for fair value measurements categorised within Level 3 of the fair value hierarchy (ie fair value measurements using significant unobservable inputs). The objective of that disclosure was to provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy, given that those fair value measurements are more subjective than those derived from observable market prices.

The proposed disclosure in ED/2009/5 was identical to a disclosure requirement in IFRS 7, although the scope of ED/2009/5 would apply to all assets and liabilities measured at fair value (ie it would not be limited to financial instruments). Paragraph 27B(e) of IFRS 7 requires an entity to disclose information about the sensitivities of fair value measurements to the main valuation assumptions (ie a measurement uncertainty analysis) for financial instruments categorised within Level 3 of the fair value hierarchy. Topic 820 currently does not have such a disclosure.

What people said

Respondents were generally supportive of a requirement to disclose information about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy. However, ED/2009/5 did not propose and IFRS 7 does not require an entity to take into account the correlation between unobservable inputs. Therefore, users of financial statements have suggested that a measurement uncertainty analysis disclosure would be more helpful if it required an entity to take into account the effect of correlation between unobservable inputs. Those users have asserted that including the effect of correlation in the analysis would help them to assess the extent to which using a different unobservable input can affect a fair value measurement.

The response to that feedback

It was clear from the outreach performed, including the comments received on the proposal in ED/2009/5 and the FASB's August 2009 exposure draft of a proposed ASU *Improving Disclosures about Fair Value Measurements*, that the measurement uncertainty analysis disclosure would be more helpful to users of financial statements if it required an entity to take into account the effect of correlation between unobservable inputs in that analysis.

Tentative conclusion

The boards agreed to require an entity to provide a measurement uncertainty analysis disclosure about fair value measurements categorised within Level 3 of the fair value hierarchy. That disclosure would require an entity to take into account the correlation between unobservable inputs when performing the measurement uncertainty analysis, if such correlation is relevant in the analysis.

In June 2010 the IASB published ED/2010/7. That exposure draft is a limited re-exposure of a proposed disclosure in ED/2009/5. The proposal in ED/2010/7 is identical to the measurement uncertainty analysis disclosure proposed in the FASB's exposure draft of proposed amendments to Topic 820.

How would an IFRS compare with US GAAP?

To reach the goal of developing common fair value measurement and disclosure requirements in IFRSs and US GAAP, the boards have worked together to ensure that fair value will have the same meaning in IFRSs and US GAAP and that their respective fair value measurement standards will be nearly identical (except for minor differences in wording and style). The IFRS and US GAAP fair value measurement standards will have the following style differences:

- there will be differences in references to other IFRSs and US GAAP—for example, regarding related party transactions, IFRSs would refer to IAS 24 *Related Party Disclosures* and US GAAP would refer to Topic 850 *Related Party Disclosures*;
- there will be differences in style—for example, IFRSs would refer to ‘an entity’ and US GAAP would refer to ‘a reporting entity’;
- there will be differences in spelling—for example, IFRSs would refer to ‘labour costs’ and US GAAP would refer to ‘labor costs’; and
- there will be different references to a particular jurisdiction—for example, IFRSs would refer to ‘government securities’ and US GAAP would refer to ‘U.S. Treasury securities’.

The boards believe that those differences would not result in inconsistent interpretations in practice by entities applying IFRSs or US GAAP. In addition, the fair value measurement standards would have the following differences:

Scope exceptions	Proposed ASU paragraph reference
<p>Different assets, liabilities and equity instruments are measured at fair value in IFRSs and US GAAP.</p> <p>The standards in IFRSs and US GAAP that require or permit fair value measurements are different. As a consequence, an asset, a liability or an equity instrument that is measured at fair value in IFRSs might not be measured at fair value in US GAAP and vice versa. The boards have separate projects to address the measurement bases in other standards (eg the projects to address the accounting for financial instruments and leases).</p>	820-10-15-2—820-10-15-3

Investments in entities that calculate net asset value per share (or its equivalent)	Proposed ASU paragraph reference
<p>There will be different accounting requirements in IFRSs and US GAAP for measuring the fair value of investments in investment company entities.</p> <p>Topic 946 <i>Financial Services—Investment Companies</i> requires an investment company entity to recognise its underlying investments at fair value on a recurring basis. Topic 820 provides a practical expedient that permits an entity with an investment in an investment company entity to use the reported net asset value without adjustment as a measure of fair value in specific circumstances. IAS 27 requires an investment company entity to consolidate its controlled underlying investments.</p> <p>Because IFRSs do not have accounting requirements that are specific to investment company entities, the IASB decided that it would be difficult to identify the circumstances in which such a practical expedient could be applied given the different practices for calculating net asset values in jurisdictions around the world.</p> <p>For example, investment company entities may report under local country GAAP, which may have recognition and measurement requirements that differ from those in IFRSs. The boards are currently reviewing the accounting for investment company entities as part of their joint project on consolidation.</p>	<p>820-10-15-4—820-10-15-5</p> <p>820-10-35-54B</p> <p>820-10-35-59—820-10-35-62</p> <p>820-10-50-6A</p> <p>820-10-55-64A</p>

Disclosure	Proposed ASU paragraph reference
<p>There will be different disclosure requirements.</p> <p>Some of the disclosures about fair value measurements will be different for IFRSs and US GAAP. For example:</p>	
<p>The IFRS would not distinguish between recurring and non-recurring fair value measurements. All fair value measurements after initial recognition in IFRSs are ‘recurring’ (ie recognised at fair value at each reporting period). For example, although an entity applying the revaluation model in IAS 16 <i>Property, Plant and Equipment</i> does not need to measure fair value at each reporting period, the entity must ensure that the carrying amount of an item of property, plant and equipment does not differ materially from fair value at the reporting date. In addition, the impairment model in IAS 36 uses recoverable amount, which is the higher of value in use and fair value less costs to sell. Although, like US GAAP, impairments in IFRSs are ‘non-recurring’, unlike US GAAP, the recognition of an impairment is not necessarily at fair value.</p>	<p>820-10-50-2(a) 820-10-50-2B</p>
<p>Because IFRSs generally do not allow net presentation for derivatives, the amounts disclosed for fair value measurements categorised within Level 3 of the fair value hierarchy might differ.</p>	<p>820-10-50-3</p>
<p>The IFRS would not require an entity to disclose information about a liability issued with an inseparable third-party credit enhancement. IFRS 7 addresses disclosures for such financial instruments.</p>	<p>820-10-50-4A</p>
<p>The IFRS would require an entity to provide, at a minimum, the disclosures specified in the IFRS. It would not encourage an entity to combine the fair value disclosures with fair value information required by other IFRSs or to disclose information about other similar measurements.</p>	<p>820-10-50-9</p>

Disclosure	Proposed ASU paragraph reference
The disclosures for plan assets would be addressed in IAS 19 <i>Employee Benefits</i> .	820-10-50-10

The boards will continue their discussions after considering the comments received on the proposals in ED/2010/7 and on the FASB's exposure draft of proposed amendments to Topic 820.

Resources

Additional information about the project is available on the Fair Value Measurement project page of the IASB Website at www.ifrs.org.

The project page gives access to:

- the discussion paper *Fair Value Measurements*, published in November 2006.
- the exposure draft *Fair Value Measurement*, published in May 2009 (ED/2009/5).
- the exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*, a limited re-exposure of a proposed disclosure in ED/2009/5, published in June 2010 (ED/2010/7).
- the letters received in response to the request for comments on the discussion paper and on ED/2009/5.
- audio recordings of public meetings held to discuss the project, the staff papers prepared for discussion at those meetings and written summaries of the decisions made at those meetings.
- the materials used at the round-table meetings held in November and December 2009 to discuss the proposals in ED/2009/5.
- the Expert Advisory Panel's report *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* and the accompanying IASB Staff Summary *Using judgement to measure the fair value of financial instruments when markets are no longer active*.
- frequently asked questions about fair value measurements in IFRSs.

The FASB's exposure draft of a proposed ASU *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* is available on the FASB's website at www.fasb.org.