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Basis for Conclusions
Exposure Draft ED/2009/5

Fair Value Measurement

Comments to be received by 28 September 2009

International
Accounting Standards
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Basis for Conclusions on Exposure Draft

Fair Value Measurement

Comments to be received by 28 September 2009

ED/2009/5

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Fair Value Measurement* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **28 September 2009.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Basis for Conclusions on the exposure draft *Fair Value Measurement*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's (IASB) considerations in developing the proposals in the exposure draft. It includes the reasons for accepting particular views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background

BC2 Several IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or equity instruments. However, those IFRSs provide disparate, and sometimes limited, guidance on how to measure fair value. That guidance has evolved piecemeal and is dispersed among the IFRSs that refer to fair value. Inconsistencies in that guidance have added to the complexity of financial reporting.

BC3 To remedy this, in September 2005 the Board added to its agenda a project to clarify the meaning of fair value and provide guidance for its application in IFRSs. The exposure draft is a result of that project and proposes a definition of fair value, a framework for measuring fair value and disclosures about fair value measurements.

BC4 These proposals would apply when other IFRSs require or permit fair value measurements or disclosures. They would not apply to measurements that are similar to fair value in some respects but that are not intended to measure fair value, such as net realisable value in IAS 2 *Inventories* or value in use in IAS 36 *Impairment of Assets*.

BC5 These proposals would not introduce new fair value measurements, nor would they 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 proposals would specify *how* entities should measure fair value and disclose fair value information; they would not specify *when* entities should measure assets and liabilities at fair value.

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BC6 In November 2005 the Board published for comment a discussion paper *Measurement Bases for Financial Accounting–Measurement on Initial Recognition*, written by the staff of the Canadian Accounting Standards Board. The Board received comment letters from 86 respondents. In January and February 2007 the IASB and the US Financial Accounting Standards Board (FASB) held round-table meetings to discuss measurement generally. Those round-table meetings were not specific to fair value measurement. The responses to that discussion paper and from the round-table meetings provided input for the measurement phase of the Board's project on the conceptual framework (a joint project with the FASB).

BC7 In November 2006 the Board published a discussion paper *Fair Value Measurements*, using Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) as a basis for forming its preliminary views. The Board used SFAS 157, together with related interpretative guidance, as a starting point for its deliberations given the consistency of SFAS 157 with much of the fair value measurement guidance in IFRSs and the need for increased convergence with US generally accepted accounting principles (GAAP). The Board received comment letters from 136 respondents.

BC8 In March 2008 the Board published a discussion paper *Reducing Complexity in Reporting Financial Instruments*. Although that paper contained a discussion of fair value, its primary purpose was to consider how to simplify the reporting of financial instruments, including, among other issues, when fair value is an appropriate measurement basis for financial instruments. In other words, that paper addressed *when* entities should measure financial instruments at fair value, not *how* to measure fair value. However, some of the responses to that paper provided information for the Board to consider about how to measure fair value. The Board received comment letters from 162 respondents.

BC9 The proposals in the draft IFRS also reflect discussions by the IASB's Expert Advisory Panel, formed in May 2008 in response to recommendations made by the Financial Stability Forum. The Panel addressed the measurement and disclosure of financial instruments when markets are no longer active. The IASB staff issued a 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.

BC10 In April 2009 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*

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Significantly Decreased and Identifying Transactions that are Not Orderly (FSP). The FSP provides guidance for:

(a) measuring fair value when the volume and level of activity for the asset or liability have significantly decreased; and

(b) identifying circumstances that indicate a transaction is not orderly.

BC11 The IASB published a *Request for views* that asked respondents whether they believed the guidance in the FSP was consistent with the Panel's report. The IASB 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 broadly consistent with the Panel's report. As a result, the Board decided to include the guidance from the FSP in the exposure draft.

BC12 In March 2009 the Board issued *Improving Disclosures about Financial Instruments*. That document amended IFRS 7 *Financial Instruments: Disclosures* to enhance disclosures about fair value measurements of financial instruments. It also reinforced existing principles for disclosures about the liquidity risk associated with financial instruments.

BC13 In developing the exposure draft *Fair Value Measurement*, the Board considered comments from respondents to the three discussion papers and to the IFRS 7 exposure draft, as well as input from the IASB's Standards Advisory Council, Analysts' Representative Group and Expert Advisory Panel on measuring and disclosing fair values of financial instruments when markets are no longer active, and from other interested parties. The Board also considered valuation issues raised by members of the FASB's Valuation Resource Group. In response, the Board reconsidered and clarified some aspects of the preliminary views it had expressed in the discussion paper *Fair Value Measurements*.

BC14 The Board will consider responses to the exposure draft in developing an IFRS on fair value measurement.

Measurement

Definition of fair value

BC15 The exposure draft proposes a framework for measuring fair value. That framework is based on the core principle that defines 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).

BC16 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.

BC17 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 transaction or distress sale). However, the existing definition of fair value:

(a) does not specify whether an entity is buying or selling the asset;

(b) is unclear what is meant by 'settling' a liability because it does not refer to the creditor, but to knowledgeable, willing parties; and

(c) does not state explicitly whether the exchange or settlement takes place at the measurement date or at some other date.

BC18 The Board believes that the proposed definition of fair value remedies these deficiencies. It also conveys more clearly that fair value assumes an orderly transaction.

BC19 In determining how to define fair value in IFRSs, the Board considered work done in its project to revise IFRS 3 *Business Combinations*. In that project, the Board considered whether differences between the definitions of fair value in US GAAP and IFRSs would result in different measurements of assets acquired and liabilities assumed in a business combination.

BC20 The Board asked valuation experts to take part in a case study involving the valuation of the identifiable assets acquired and liabilities assumed in a sample business combination. As a result, the Board learned that such differences are unlikely to arise because transaction costs are not a component of fair value in either definition. The Board observed that the definitions use different words to articulate essentially the same concepts in two general areas: the market-based measurement objective and, for liabilities, non-performance risk.

BC21 However, the valuation experts identified potential differences in particular areas. For example, SFAS 157 defines fair value as an exit price between market participants and IFRSs define fair value as an exchange price in an arm's length transaction. The valuation experts told the Board

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that an exit price for an asset or liability acquired or assumed in a business combination might differ from an exchange price (entry or exit) if:

(a) an entity's intended use for an acquired asset is different from its highest and best use or

(b) a liability is measured on the basis of settling it with the creditor rather than transferring it to a third party and the entity determines that there is a difference between those measurements. Paragraphs BC69 and BC70 discuss whether there is a difference between the settlement and transfer notions.

BC22 However, the Board understood that ways of measuring assets on the basis of their 'defensive value' in accordance with paragraph A12 of SFAS 157 were developing, and it was too early to assess the significance of any differences that might result. It was also not clear whether entities would use different valuation techniques to measure the fair value of liabilities assumed in a business combination.

Current exit price

BC23 An exit price of an asset or liability embodies expectations about the future cash inflows and outflows associated with the asset or liability from the perspective of market participants at the measurement date. An entity generates cash inflows from an asset by using the asset or by selling it. Even if an entity intends to generate cash inflows from an asset by using it rather than by selling it, an exit price embodies expectations of cash flows arising from the use of the asset by selling it to a market participant that would use it in the same way. Thus, the Board believes that an exit price is always a relevant definition of fair value, regardless of whether an entity intends to use an asset or to sell it.

BC24 Similarly, a liability gives rise to outflows of cash (or other economic resources) as an entity fulfils the liability over time or when it transfers the liability to another party. Even if an entity intends to fulfil the liability over time, exit price embodies expectations of related cash outflows because a market participant transferee would ultimately be required to fulfil the liability. Thus, the Board believes that an exit price is always a relevant definition of fair value, regardless of whether an entity intends to fulfil the liability or to transfer it to another party that will fulfil it.

BC25 In developing the proposed definition of fair value, the Board completed a standard-by-standard review of fair value measurements required or permitted in IFRSs to assess whether the IASB or its predecessor intended

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each fair value measurement basis to be a current exit price. If a current exit price clearly was not the intention, the Board initially considered using another measurement basis to describe the objective. The other likely measurement basis candidate was 'current entry price'. The Board defined current entry price as follows:

> The price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants (including the amount imposed on an entity for incurring a liability) at the measurement date.

BC26 The definition of current entry price, like fair value, assumes an orderly transaction between market participants at the measurement date. It is not necessarily the same as the actual price an entity paid to acquire an asset or received to incur a liability, eg if that transaction was not at arm's length.

BC27 During the standard-by-standard review, the Board asked various parties to provide input on whether, in practice, they interpret 'fair value' in a particular context in IFRSs as a current entry price or a current exit price. The Board used that feedback in determining whether to define fair value as a current exit price, or to remove the term 'fair value' and use the terms 'current exit price' and 'current entry price' depending on the measurement objective in each IFRS that uses the term 'fair value'.

BC28 As a result of the standard-by-standard review, the Board concluded that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market.[*] Therefore, the Board considered it unnecessary to make a distinction between a current entry price and a current exit price in IFRSs with a market-based measurement objective (ie fair value), and decided to define fair value as a current exit price.

BC29 The Board determined that several fair value measurement requirements in IFRSs were inconsistent with a current exit price. For those fair value measurements, the exposure draft proposes either to exclude the measurement from its scope (ie the measurement of financial liabilities with a demand deposit) or to amend the relevant IFRSs to replace the

[*] Some have questioned the assertion that entry and exit prices are equal in those situations, citing bid-ask spreads as a potential difference between entry and exit prices in the same market. In reaching its conclusion, the Board acknowledged that such a difference could exist but attributed any such difference to transaction costs, which are not included in the price when measuring fair value.

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term 'fair value' with another term that reflects the intended measurement objective (ie for share-based payment transactions and reacquired rights in a business combination) (see paragraphs D4, D5 and D7 of the draft IFRS).

BC30 Some respondents to the discussion paper argued that defining fair value as a current exit price at initial recognition is inappropriate for operating assets (eg property, plant and equipment acquired in a business combination). The Board noted that a current exit price considers a market participant's ability to generate economic benefits by using an asset or by selling it to another market participant. As explained in paragraphs BC61–BC63, current replacement cost plays an important role in determining an exit price for such assets.

The asset or liability

BC31 A fair value measurement considers the characteristics of the asset or liability, eg the condition and location of the asset and restrictions, if any, on its sale or use. Restrictions on the sale or use of an asset affect its fair value if market participants would consider the restrictions when pricing the asset at the measurement date.

BC32 Other IFRSs specify whether a fair value measurement considers an individual asset or liability or a group of assets or liabilities. For example, IAS 36 stipulates that an entity should measure the fair value less costs to sell for a cash-generating unit when assessing the recoverable amount.

BC33 For financial instruments, the Board's preliminary view in the discussion papers *Fair Value Measurements* and *Reducing Complexity in Reporting Financial Instruments* was that the measurement objective is to measure fair value at the individual instrument level. In other words, the unit of account for a financial instrument is the single instrument. That conclusion is consistent with the guidance in paragraphs AG71 and AG72 of IAS 39 *Financial Instruments: Recognition and Measurement*.*

BC34 Many respondents to the *Fair Value Measurements* discussion paper argued that a fair value measurement should reflect a blockage factor. A blockage factor adjusts for the illiquidity of a large holding of financial instruments. Those respondents noted that in their experience, an entity will often receive a lower price per unit for the sale of a holding than if it were to sell each financial instrument individually.

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* Paragraph D29 of Appendix D proposes to relocate the requirements on unit of account from paragraphs AG71 and AG72 to a new paragraph 48B.

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BC35 The Board proposes not to include blockage factors in a fair value measurement because:

(a) as specified in IAS 39, the unit of account represented by the exit transaction is the individual instrument; and

(b) market participant sellers will enter into a transaction at the most advantageous price for the instrument. A particular 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.

The transaction: general principles

BC36 The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability (ie it does not consider entity-specific factors that might influence the transaction). It follows that the reporting entity does not need to have the intention or ability to enter into a transaction on that date.

The transaction: reference market

BC37 In the discussion paper *Fair Value Measurements* the Board expressed the preliminary view that a fair value measurement assumes the sale of an asset or transfer of a liability in the principal market for the asset or liability, or if there is no principal market, in the most advantageous market for the asset or liability.

BC38 The Board reached that view because it concluded that in most cases the principal market for an asset or liability will be the most advantageous market and that an entity need not continuously monitor different markets in order to determine which market is most advantageous at the measurement date. Furthermore, the Board reasoned that the principal market is the most liquid market and therefore provides the most representative input for a fair value measurement.

BC39 Respondents generally agreed with the Board's preliminary view, but noted that an entity is most likely to enter into a transaction in the most advantageous market. Some respondents also suggested that a fair value measurement should reflect the price in the market in which an entity usually enters, or expects to enter, into a transaction. They asserted that this is likely to be the most advantageous market.

BC40 The Board agreed with these respondents and noted that most entities aim to maximise profits. Therefore, the exposure draft proposes that a

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fair value measurement should assume that the sale of an asset or transfer of a liability takes place in the most advantageous market to which the entity has access. To mitigate concerns about search costs, the Board clarified that an entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market. Moreover, it is presumed that the entity would normally enter into a transaction for the asset or liability in the most advantageous market.

BC41 Some respondents questioned how to determine the market in which the transaction would take place when there is not an observable market for the asset or liability. The Board noted that a 'market' does not need to be observable to exist, eg there does not need to be an organised exchange for the asset or liability. As a result, the exposure draft clarifies that in such cases an entity should consider the characteristics of market participants who would enter into a transaction for the asset or liability (see paragraphs 13 and 14 of the draft IFRS).

Market participants

BC42 The exposure draft emphasises that a fair value measurement is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement uses the assumptions market participants would use when pricing the asset or liability. Market participants are buyers and sellers in the most advantageous market for the asset or liability.

BC43 The existing definition of fair value in IFRSs refers to 'knowledgeable, willing parties in an arm's length transaction'. The Board believes that this expresses the same notion as the definition of market participants proposed in the exposure draft, but that the existing definition is less clear. The exposure draft defines market participants as independent of each other (they are not related parties), knowledgeable about the asset or liability, and able and willing to enter into a transaction for the asset or liability.

BC44 Some respondents to the discussion paper questioned whether market participants would be as knowledgeable as the reporting entity about the asset or liability given that the reporting entity might have access to information that is not available to other market participants (information asymmetry).

BC45 In the Board's view, if a market participant is willing to enter into a transaction for an asset or a liability, it would undertake efforts, including usual and customary due diligence efforts, necessary to become knowledgeable about the asset or liability and would factor any related risk

into the measurement. The market participant and the reporting entity are presumed to be equally knowledgeable about the asset or liability, although neither party is perfectly knowledgeable. In other words, a fair value measurement does not reflect information asymmetry, although it does reflect information uncertainty (ie the uncertainty an entity faces because it does not have perfect knowledge about the timing and amount of future cash flows).

The price

BC46 The Board's preliminary view in the discussion paper was that the price used to measure fair value should not be reduced (for an asset) or increased (for a liability) by the costs an entity would incur when selling the asset or transferring the liability (transaction costs).

BC47 Some respondents to the discussion paper stated that transaction costs are unavoidable when entering into a transaction for an asset or a liability. However, the Board noted that the costs may differ depending on how a particular entity enters into a transaction. Therefore, the exposure draft proposes that transaction costs are not a characteristic of an asset or a liability, but are a characteristic of the transaction. An entity accounts for those costs in accordance with relevant IFRSs.

BC48 Transaction costs are different from transport costs, which are the costs that would be incurred to transport the asset to its most advantageous market. Transaction costs arise from a transaction and do not change the characteristics of the asset or liability. Transport costs, on the other hand, arise from an event (transport) that does change a characteristic of an asset (its location). Therefore, the exposure draft proposes that if location is a characteristic of an asset, the price in the most advantageous market should be adjusted for the costs that would be incurred to transport the asset to that market.

Application to assets: highest and best use

BC49 Highest and best use is a valuation concept used to value many non-financial assets (eg real estate). In broad terms, the highest and best use of an asset is the use that would maximise the value of the asset or the group of assets and liabilities (eg a business) within which the asset would be used by market participants.

BC50 Some respondents to the discussion paper questioned how to determine whether market participants would have a use for an asset that is different from an entity's current use. The exposure draft clarifies that an entity need not perform an exhaustive search for other potential uses

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if there is no evidence to suggest that the current use of an asset is not its highest and best use.

BC51 In the Board's view, financial assets do not have alternative uses. For example, although entities sometimes repackage or modify financial assets for securitisations, those activities change the characteristics of the financial assets so that they become different assets. The objective of a fair value measurement is to measure the asset that exists at the measurement date.

BC52 The Board concluded that the highest and best use concept does not apply to liabilities. An entity might be able to change the cash flows from a liability by discharging it in different ways (eg fulfilment in the normal course of business, immediate settlement with the counterparty or immediate transfer to another party). However, the Board does not view those as alternative uses. Moreover, although an entity might have entity-specific advantages or disadvantages that enable it to fulfil a liability more or less efficiently than other market participants, those entity-specific factors do not affect fair value.

BC53 Fair value considers the highest and best use of an asset from the perspective of market participants. This is the case even if the entity acquires an asset but, for competitive or other reasons, does not intend to use it actively or does not intend to use the asset in the same way as other market participants (eg if an intangible asset provides 'defensive value' because the acquirer holds the asset to keep it out of the hands of competitors). When revising IFRS 3 in 2008, the Board decided that an entity must recognise such an asset at fair value. The draft IFRS provides guidance for measuring the fair value of such assets (see paragraph 19).

BC54 Users of financial statements asked the Board to consider how to account for assets when their highest and best use within a group of assets is different from their current use by the entity. For example, the fair value of a factory is linked to the value of the land on which it is situated. The fair value of the factory would be nil if the land has an alternative use that assumes the factory is demolished. The Board concluded that measuring the factory at nil would not provide decision-useful information when an entity is using that factory in its operations. In particular, users would want to see depreciation on that factory so that they could assess the economic resources consumed in generating cash flows from its operation.

BC55 Therefore, the draft IFRS proposes in paragraph 20 that an entity should separate the fair value of the asset group into the following components:

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(a) the value of the assets assuming their current use (ie the amount that would be their fair value if the current use were the highest and best use).

(b) the amount by which the fair value of the assets differs from their value in their current use (ie the incremental value of the asset group).

Application to assets: valuation premise

BC56 As an application of the highest and best use concept, the exposure draft identifies two valuation premises that may be relevant when measuring the fair value of an asset:

(a) The 'in-use' valuation premise applies when the highest and best use of an asset is to use it with other assets and liabilities as a group. The in-use valuation premise assumes that the exit price would be the price for a sale to a market participant that has, or can obtain, the other assets and liabilities needed to generate cash inflows by using the asset (complementary assets and liabilities).

(b) The 'in-exchange' valuation premise applies when the highest and best use of an asset is to use it on a stand-alone basis. It assumes that the sale would be to a market participant that uses the asset on its own.

BC57 The Board concluded that the in-exchange valuation premise should be used when pricing a financial asset because, in an efficient market, the price determined using an in-exchange valuation premise reflects the benefits that market participants would derive from holding the asset in a diversified portfolio. Therefore, an entity will obtain no incremental benefit from holding the asset in a portfolio.

BC58 The following paragraphs answer common questions about the valuation premise:

(a) Does the in-use valuation premise result in an allocation from the fair value of an entire asset group (paragraph BC59)?

(b) Is the in-use valuation premise compatible with an exit price (paragraph BC60)?

(c) Is the exit price of specialised equipment equal to its scrap value (paragraphs BC61–BC63)?

(d) Does the in-use valuation premise lead to the same result as value in use (paragraph BC64)?

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(e) Is the in-use valuation premise consistent with deprival value (paragraphs BC65 and BC66)?

In-use valuation premise for a single asset

BC59 Respondents to the discussion paper asked for guidance on allocating to an individual asset the value of an asset group under the in-use valuation premise. The exposure draft clarifies that both the in-use valuation premise and the in-exchange valuation premise assume that the asset being measured is sold individually and not as part of a group of assets or a business. Thus, even when the in-use valuation premise is used, the exit price for an asset is a price for that asset individually. It is not an allocation of fair value determined for an entire asset group.

In-use valuation premise and exit price

BC60 Many respondents to the discussion paper perceived conflicts between the in-use valuation premise and the exchange notion encompassed within the definition of fair value. The Board considered those comments and concluded that there is no conflict. If the highest and best use of an asset is 'in use', market participant buyers would willingly pay a price that reflects that use and market participant sellers would not willingly accept a lower price. Thus, the in-use valuation premise considers the cash flows that market participants would expect to generate from using the asset. Therefore, the exposure draft clarifies that an exit price considers a market participant's ability to generate economic benefit either by using an asset or by selling it to a third party.

Scrap value

BC61 Some respondents expressed concerns about using an exit price notion for specialised assets that have a significant value when used together with other assets, for example in a production process, but have little value if sold for scrap to another market participant who does not have complementary assets. They were concerned that an exit price would be based on that scrap value (particularly given the requirement to prioritise observable market prices over other inputs, see paragraph BC85) and would not reflect the value that an entity expects to generate by using the asset in its operations. However, the exposure draft clarifies that this is not the case. In such situations, the scrap value for the individual assets would be irrelevant because the in-use valuation premise would be appropriate: an exit price reflects the sale of the asset to a market

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participant that has, or can obtain, the complementary assets and liabilities needed to use the specialised assets in its own operations. In effect, the market participant buyer steps into the shoes of the entity that holds those specialised assets.

BC62 It is unlikely in such a situation that a market price, if available, would capture the value the specialised asset contributes to the business. When a market price does not capture the characteristics of the asset (eg if that price represents an in-exchange valuation premise such as a scrap price rather than an in-use valuation premise), that price will not represent fair value. In such a situation, an entity will need to measure fair value using discounted cash flows (an income approach) or the cost to replace or recreate the asset (a cost approach) depending on the circumstances and the information available. Paragraphs 38–40 of the draft IFRS describe the use of valuation techniques when measuring fair value.

BC63 The Board favoured the principle underlying the current replacement cost approach (the economic principle of substitution) for measuring tangible assets using the in-use valuation premise. The economic principle of substitution states that a market participant will pay no more for an asset than the amount for which it could replace the service capacity of the asset. It follows that the fair value of an asset would not exceed its current replacement cost. The Board acknowledged that it is unlikely in practice that an entity will be able to use a market approach valuation technique to measure the fair value of a tangible asset using the in-use valuation premise.

Value in use

BC64 The objective of a fair value measurement using the in-use valuation premise differs from the objective of value in use as described in IAS 36. Value in use reflects the future cash flows that the entity expects to derive from the asset (or asset group) and does not adjust those cash flows to reflect market participant expectations. The resulting value is an entity-specific value. In comparison, a fair value measurement assuming an in-use valuation premise is a market-based measurement, not an entity-specific measurement. However, in many other respects, a fair value measured assuming the in-use valuation premise is likely to be the same as market-based value in use.

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Deprival value

BC65 Some advocate measuring assets using an approach known as deprival value (also called 'value to the business'). Deprival value represents the loss that an entity would suffer if it were deprived of the asset being measured. Deprival value is the lower of the replacement cost of an asset (ie the amount the entity would need to pay to replace the asset) and its recoverable amount. The asset's recoverable amount is the higher of its net realisable value (the amount that can be obtained by selling the asset, net of selling expenses) and its value in use (the present value of the future net cash flows from continued use of the asset within the business and its ultimate disposal).

BC66 Deprival value is similar to the cost approach described in paragraph 38(c) of the draft IFRS in that replacement cost is integral to both approaches. Using deprival value, the asset's replacement cost is reduced when it exceeds the asset's recoverable amount. Using the cost approach described in the draft IFRS, the asset's replacement cost is adjusted for obsolescence factors to reflect the service capacity of the asset. The primary difference between deprival value and the cost approach is that deprival value is based on entity-specific information, such as the entity's estimate of the cost to replace the asset, whereas the cost approach uses market participant assumptions. Although the two approaches may produce similar results in some circumstances, the entity-specific focus of deprival value is not consistent in concept, nor sometimes in practice, with the market-based focus of fair value.

Application to liabilities: general principles

BC67 The exposure draft proposes that a fair value measurement assumes that a liability is transferred to a market participant at the measurement date. Because the liability is transferred to a market participant, the liability continues and the market participant transferee would be required to fulfil it; it is not settled with the counterparty or otherwise extinguished.

BC68 In many cases, an entity might not intend to transfer its liability to a third party. For example, an entity might have advantages relative to the market that would make it more beneficial for the entity to fulfil the liability using its own internal resources. A fair value measurement provides a market benchmark to use as a basis for assessing an entity's advantages or disadvantages in performance or settlement relative to the

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market. Therefore, when a liability is measured at fair value, the relative efficiency of an entity in settling the liability using its own internal resources appears in profit or loss over the course of its settlement, and not before.

BC69 In the Board's view, the fair value of a liability from the perspective of market participants who owe the liability is the same regardless of whether it is settled or transferred. This is because both a settlement and a transfer of a liability reflect all costs incurred, whether direct or indirect, and that the entity faces the same risks as a market participant transferee.

BC70 When determining the settlement amount, an entity will bear in mind that it does not have perfect knowledge about the timing and amount of the cash outflows. It will also have regard to its desire to earn a profit on all of its activities, including fulfilling the obligation. Similarly, when determining the amount to demand to assume a liability, market participant transferees will bear in mind that they do not have perfect knowledge about the timing and amount of the cash outflows and its desire to earn a profit on fulfilling the obligation. As a result, the Board concluded that similar thought processes are needed to estimate both the amount to settle a liability and the amount to transfer that liability.

BC71 Some respondents to the discussion paper were concerned about how to measure fair value when there is not an observable market price for the transfer of a liability (eg because the liability is legally restricted from being transferred). In those situations, the exposure draft proposes that an entity should measure the fair value of the liability using the same methodology that the counterparty would use to measure the fair value of a corresponding asset.

BC72 Thus, in the Board's view, the fair value of a liability equals the fair value of a properly defined corresponding asset (ie an asset whose features mirror those of the liability), assuming an exit from both positions in the same market. In reaching its decision, the Board considered whether the effects of illiquidity could create a difference between those values. The Board noted that the effects of illiquidity are difficult to differentiate from credit-related effects. The Board concluded that there was no conceptual reason why the liability value would diverge from the corresponding asset value in the same market given that the contractual terms are the same.

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Application to liabilities: non-performance risk

BC73 The exposure draft proposes that a fair value measurement assumes that the non-performance risk related to a liability (ie the risk that an entity will not fulfil an obligation) is the same before and after its transfer. Those who might hold the entity's obligations as assets would consider the effect of the entity's credit risk and other risk factors when pricing those assets. Accordingly, the exposure draft proposes that a fair value measurement for a liability should consider the effect of the reporting entity's own credit risk (credit standing) and other non-performance risk factors.

BC74 Few respondents to the discussion paper questioned the decision-usefulness of reflecting the non-performance risk of a liability at initial recognition. However, some questioned the decision-usefulness of doing so after initial recognition, because they argued that it would lead to counter-intuitive and potentially confusing reporting (ie 'gains' for credit deterioration and 'losses' for credit improvements). The Board understands that these concerns are strongly held, but concluded that addressing them is beyond the scope of this project. The purpose of this project is to define fair value, not to determine when to use fair value. A measurement that does not consider the effect of an entity's non-performance risk is not a fair value measurement. The Board plans to consider these concerns in a separate document that it is developing for public comment.

Application to liabilities: restrictions

BC75 The Board concluded that a restriction on an entity's ability to transfer a liability does not affect the fair value of the liability. The fair value of a liability, unlike an asset, is not a function of marketability, but of performance. A market participant transferee will be required to fulfil the obligation (ie settle the obligation with the counterparty or otherwise fulfil the obligation) and would take that into account when determining the price it would demand to assume the liability from the entity. In other words, the market participant transferee, like the reporting entity, must perform to be relieved of the obligation.

Fair value at initial recognition

BC76 In the discussion paper the Board asked respondents whether it is appropriate to use a measurement that includes inputs that are not observable in a market (unobservable inputs) as fair value at initial recognition if this measurement is different from the transaction price.

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The Board did not express a preliminary view on this issue. Respondents' views ranged from the view that the transaction price is always the best evidence of fair value at initial recognition unless the fair value is measured using only observable inputs (the approach in paragraph AG76 of IAS 39) to the view that the transaction price might sometimes, but not always, represent fair value at initial recognition, and that the degree of observability of inputs is not always the best indicator of whether this is the case (the approach in paragraph 17 of SFAS 157).*

BC77 The Board concluded that fair value at initial recognition should be measured in accordance with the proposals in the exposure draft, using both observable and unobservable inputs (as appropriate). That value should be measured without regard to whether it would result in a gain or loss at initial recognition of the asset or liability. Determining whether to recognise 'day 1' gains or losses is beyond the scope of this project. An entity would refer to relevant IFRSs for the asset or liability when determining whether to recognise those amounts (eg IAS 39 for financial instruments).

BC78 In reaching the above conclusions, the Board considered whether to require the recognition of a day 1 gain or loss for a financial instrument if the transaction price for the instrument differs from its fair value at initial recognition. The Board concluded that it was beyond the scope of this project to change the recognition threshold in paragraph AG76 of IAS 39. Thus, in accordance with IAS 39, an entity would not recognise a day 1 gain or loss for a financial instrument unless its fair value is evidenced by comparison with observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets.

BC79 Although the Board did not change the recognition threshold, it proposes to amend IAS 39 to clarify that the fair value of financial instruments at initial recognition should be measured in accordance with the proposals in the exposure draft and that any deferred amounts arising from the application of paragraph AG76 are separate from the fair value measurement. In other words, the recognition threshold in paragraph AG76 is not a constraint when measuring fair value; rather it determines whether the resulting difference (if any) between fair value at initial recognition and the transaction price is recognised.

* See paragraph D29 of Appendix D for proposed amendments to paragraph AG76.

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Valuation techniques

BC80 When measuring fair value, the objective of using a valuation technique is to estimate the price at which an orderly transaction would take place between market participants at the measurement date.

BC81 To meet this objective, the exposure draft proposes that valuation techniques used to measure fair value should be consistent with the market approach, income approach or cost approach. The exposure draft does not propose a hierarchy of valuation techniques because particular valuation techniques might be more appropriate in some circumstances than in others. Determining the appropriateness of valuation techniques in the circumstances requires judgement.

BC82 Some respondents to the discussion paper questioned whether a cost approach is consistent with an exit price definition of fair value because they think that the cost to replace an asset is more consistent with an entry price than an exit price. The Board noted that an entity's cost to replace an asset would equal the amount that a market participant buyer of that asset (who would use it similarly) would pay to acquire it (ie the entry price and the exit price would be equal in the same market). Furthermore, paragraphs BC61–BC63 explain the Board's reasons for concluding that the cost approach can be relevant as a means of measuring fair value, particularly when an asset is measured using the in-use valuation premise.

BC83 The exposure draft proposes that a fair value measurement should include an adjustment for risk if market participants would include one when pricing the asset or liability. The Board noted that it might be difficult for an entity to quantify this adjustment in some cases, but concluded that this difficulty does not justify the exclusion of this input if market participants would consider it. The exposure draft focuses on the need to adjust for the risk inherent in a particular valuation technique used to measure fair value, such as a pricing model (model risk) and the risk inherent in the inputs to the valuation technique (input risk).

Fair value hierarchy

BC84 A valuation technique maximises the use of relevant observable inputs and minimises the use of unobservable inputs. To increase consistency and comparability in fair value measurements and related disclosures, the exposure draft proposes a fair value hierarchy that prioritises the inputs used to measure fair value into three levels, considering the

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relative subjectivity of the inputs. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets and liabilities (Level 1) and the lowest priority to inputs that are not based on observable market data (Level 3).

BC85 The fair value hierarchy also categorises the fair value measurements resulting from those inputs. A fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. For example, a valuation technique using solely Level 2 inputs would be a Level 2 fair value measurement. However, if the valuation technique also uses a Level 3 input that is significant to the fair value measurement in its entirety, the resulting measurement would be a Level 3 fair value measurement.

Level 1 inputs

BC86 Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets and liabilities. The Board concluded that these prices generally provide the most reliable evidence of fair value and should be used to measure fair value whenever available. The exposure draft defines an active market as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. The Board concluded that although different words are used, this definition is consistent with the definitions of an active market in IFRSs:

(a) IAS 36, IAS 38 *Intangible Assets* and IAS 41 state that an active market is one in which '(i) the items traded in the market are homogeneous; (ii) willing buyers and sellers can normally be found at any time; and (iii) prices are available to the public.'

(b) IAS 39 states that an active market is one in which 'quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.'

BC87 The exposure draft proposes that when an entity holds a large number of similar assets and liabilities that are required to be measured at fair value and a quoted price in an active market is not readily accessible for each of those assets and liabilities, the entity can use an alternative pricing method that does not rely exclusively on quoted prices as a practical expedient (although the resulting fair value measurement is a lower level

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measurement). This is a departure from the principle that a fair value measurement should maximise the use of relevant observable inputs. However, the Board regards this particular practical expedient as justified on cost-benefit grounds.

Level 2 inputs

BC88 Level 2 inputs are all inputs other than quoted prices included in Level 1 that are observable (either directly or indirectly) for the asset or liability. The Board concluded that it is appropriate to include in Level 2 market-corroborated inputs that might not be directly observable, but are based on or supported by observable market data, because such inputs are less subjective than unobservable inputs classified within Level 3. Furthermore, the Board concluded that additional guidance is needed to address measuring fair value in markets that are not active and when transactions are not orderly (see paragraphs BC10 and BC11).

Level 3 inputs

BC89 Level 3 inputs are inputs for the asset or liability that are not based on observable market data (unobservable inputs).

BC90 Some respondents to the discussion paper stated that it would be misleading to describe a measurement using significant unobservable inputs as a fair value measurement. They also expressed concerns that unobservable inputs may include entity-specific factors that market participants would not consider. Therefore, they suggested that the Board should use a different label for measurements that use significant unobservable inputs. However, the Board concluded that it would be more helpful to users to use the label 'fair value' for all three levels of the hierarchy described in the exposure draft, for the following reasons:

(a) The proposed definition of fair value identifies a clear objective for valuation techniques and the inputs to them: consider all factors that market participants would consider and exclude all factors that market participants would exclude. An alternative label for Level 3 measurements would be unlikely to identify such a clear objective.

(b) The distinction between Levels 2 and 3 is inevitably subjective. It is undesirable to adopt different measurement objectives on either side of such a subjective boundary.

(c) Adopting a different label for Level 3 measurements would make the drafting of IFRSs considerably more complex because each

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reference to fair value would have to be replaced by references to fair value and the other measurement basis, and would need to include a description of when the two measurement bases are used.

Rather than requiring a different label for measurements derived using significant unobservable inputs, the Board favours enhanced disclosure for those measurements (see paragraph 57(e) of the draft IFRS).

BC91 The Board accepts that the starting point for Level 3 inputs might be estimates developed by the reporting entity. However, the entity must adjust those inputs if reasonably available information indicates that other market participants would use different data when pricing the asset or liability or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy).

BC92 Some respondents expressed concerns that an entity would be compelled by its auditors or regulators to undertake exhaustive efforts to obtain information about the assumptions that market participants would use in pricing the asset or liability. Furthermore, they were concerned that their judgement would be questioned when asserting the absence of contrary data. The exposure draft proposes that such exhaustive efforts would not be necessary. However, when information about market participant assumptions is reasonably available, an entity cannot ignore it.

Inputs based on bid and ask prices

BC93 In some situations, inputs might be determined on the basis of bid and ask prices, eg in a dealer market where the bid price represents the price the dealer is willing to pay and the ask price represents the price at which the dealer is willing to sell. IAS 39 requires the use of bid prices for long positions (assets) and ask prices for short positions (liabilities). IAS 36 and IAS 38 have similar requirements. Bid-ask spread guidance in IFRSs is discussed only in terms of observable market prices; no bid-ask spread guidance is provided for valuation techniques when there is no active market.

BC94 Some respondents to the discussion paper agreed that a single bid-ask spread pricing method, as currently described in IFRSs, would maximise the consistency and comparability of fair value measurements using bid and ask prices. However, many respondents stated that because different market participants enter into transactions at different prices within a bid-ask spread, the resulting measurements would not be relevant in all cases. The Board noted that different entities in different markets carry

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out transactions at different points within a bid-ask spread. As a result, the exposure draft proposes that fair value measurements should use the price within the bid-ask spread that is most representative of fair value in the circumstances.

BC95 Furthermore, the Board concluded that the bid-ask guidance applies at all levels of the fair value hierarchy, provided that the price is consistently determined. However, the Board acknowledged that bid-ask spreads might not be observable for some assets and liabilities, particularly those that are not traded in a market (eg for many non-financial assets and liabilities). As a result, the exposure draft proposes that an entity need not undertake exhaustive efforts to determine a bid-ask spread when such a spread is not observable either directly or indirectly.

BC96 In developing this proposal, the Board observed that, in many situations, bid and ask prices establish the boundaries within which market participants would negotiate the price in the exchange for the related asset or liability. Having clarified the fair value measurement objective in the exposure draft, the Board concluded that an entity should use judgement in meeting that objective. Accordingly, the use of bid prices for long positions (assets) and ask prices for short positions (liabilities) is permitted but not required. Moreover, because the exposure draft does not propose the use of bid prices for long positions (assets) and ask prices for short positions (liabilities), it does not contain guidance for offsetting positions.

BC97 IAS 39 defines the 'bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (eg for counterparty credit risk) are not included in the term 'bid-ask spread'. Some respondents to the discussion paper asked whether the bid-ask guidance proposed in the discussion paper reflected that view, noting that a potential difference between entry prices and exit prices could be when entities enter into transactions at different points within the spread. The Board decided not to specify what, if anything, is in a bid-ask spread in addition to transaction costs. Rather, an entity will need to make that assessment when determining the point within the bid-ask spread that is most representative of fair value in the circumstances.

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Disclosures

BC98 The disclosure requirements about fair value measurements in IFRSs vary. The Board believes that having proposed a framework for measuring fair value, the exposure draft should also propose expanded disclosures about fair value measurements.*

BC99 The exposure draft proposes a comprehensive disclosure framework that (a) combines the disclosures currently required by SFAS 157 and IFRSs and (b) provides additional disclosures that users of financial statements have suggested would be useful. In developing the proposals, the Board received input from users and preparers of financial statements and the IASB's Expert Advisory Panel.

BC100 Some respondents to the exposure draft *Improving Disclosures about Financial Instruments*, published in October 2008, questioned the use of two significance thresholds in the disclosure requirements: one relating to the significance of an input to a fair value measurement in its entirety (consistent with the fair value hierarchy) and the other relating to the significance of the measurement to, for example, total assets or liabilities and profit or loss (consistent with current requirements in IFRSs).

BC101 The Board concluded that such a distinction is necessary because significance depends on the circumstances. The significance of an input relates to that input's effect on the fair value measurement. The significance of the fair value measurement relates to that measurement's effect on the assets or liabilities of the entity, and any changes in that measurement can affect profit or loss.

Sensitivity analysis

BC102 To provide users of financial statements with a sense of the potential variability of fair value measurements, the exposure draft proposes that information about the use of valuation techniques should be disclosed, in particular the sensitivities of fair value measurements to the main valuation inputs.

* The draft IFRS includes some disclosure requirements from IFRS 7 (as amended in March 2009). The requirements in the draft IFRS are not limited to financial instruments and would be applied to fair value measurements of other assets and liabilities, as applicable.

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BC103 In reaching this conclusion, the Board considered the view that disclosure of sensitivities could be difficult, particularly when there are many inputs to which the disclosure would apply and the assumptions are interdependent. However, the Board noted that a detailed quantitative disclosure of sensitivity inputs is not required for all inputs (only for those inputs for which reasonably possible alternative assumptions could result in a significantly different estimate of fair value) and that the disclosure does not require the entity to reflect interdependencies between assumptions.

BC104 Additionally, the Board considered whether this disclosure might imply that a fair value established by a valuation technique is less reliable than one established by other means. The Board noted that fair value measurements determined using valuation techniques are more subjective than those derived from an observable market price, and concluded that users need information to help them assess the extent of this subjectivity.

Valuation techniques and inputs to valuation techniques

BC105 The exposure draft proposes requiring the disclosure of the methods and inputs used in a fair value measurement, including the information used to develop those inputs. The Board received feedback from users of financial statements and the IASB's Expert Advisory Panel that such a disclosure is necessary, particularly when limited or no market information is available. Therefore, the Board concluded that such a disclosure requirement would improve the transparency of fair value measurements.

Interim financial reporting

BC106 For financial instruments, the exposure draft proposes that particular fair value disclosures required in annual financial statements would also apply for interim financial reports. This differs from the approach proposed for non-financial assets and non-financial liabilities, for which there is no specific fair value disclosure requirement beyond the existing requirements in IAS 34 *Interim Financial Reporting*. The Board concluded that the benefit of requiring incremental disclosures for financial instruments outweighed the associated costs given the increased interest in those instruments since the inception of the credit crisis.

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Effective date and transition

BC107 The Board will set the effective date for the proposals in the exposure draft when it approves the IFRS on fair value measurement. The Board normally sets an effective date of between six and eighteen months after issuing a standard.

BC108 The Board believes that a change in the methods used to measure fair value would be inseparable from a change in the fair value measurements (ie as new events occur or as new information is obtained, eg through better insight or improved judgement). Therefore, the Board proposes that the IFRS should be applied prospectively (in the same way as a change in accounting estimate).

Application in emerging markets

BC109 The Board believes that the principles in the exposure draft should apply to all fair value measurements in all jurisdictions, including emerging markets and developing economies. The Board does not believe that it needs to develop additional guidance for those markets and economies.

Convergence with US GAAP

BC110 As noted in paragraph BC7, the Board's starting point in developing the exposure draft was SFAS 157. The Board believes that the proposals in the exposure draft are largely consistent with SFAS 157, as amended, except in the following respects:

(a) Scope. Unlike SFAS 157, the proposed IFRS would apply to leasing arrangements. However, it would not apply to the measurement of reacquired rights in a business combination or financial liabilities with a demand feature. (Paragraph BC29)

(b) Reference market. Unlike SFAS 157, which assumes the transaction to sell the asset or transfer the liability takes place in the principal market (or, in the absence of a principal market, the most advantageous market), the exposure draft proposes that an entity should assume that the transaction takes place in the most advantageous market to which the entity has access. (Paragraphs BC37–BC41)

(c) Highest and best use. Unlike SFAS 157, the exposure draft proposes presentation requirements for circumstances when an entity uses

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an asset together with other assets in a way that differs from the highest and best use of the asset. (Paragraphs BC54 and BC55)

(d) Blockage factors. Unlike SFAS 157, which specifies the unit of account for financial instruments measured within Level 1 of the fair value hierarchy, the draft IFRS is silent on the unit of account for financial instruments. IAS 39 specifies the unit of account for financial instruments as the individual instrument. This applies to all three levels of the fair value hierarchy. (Paragraphs BC34 and BC35)

(e) Day 1 gains or losses. Unlike SFAS 157, which implicitly requires the recognition of day 1 gains or losses even if the fair value measurement uses unobservable inputs, the exposure draft defers to the relevant standards for the asset or liability (eg IAS 39 for financial assets and financial liabilities) to determine whether to recognise the gain or loss. (Paragraphs BC76–BC79)

(f) Valuation premise and financial instruments. Unlike SFAS 157, the exposure draft states explicitly that the in-use valuation promise is not relevant to financial assets. (Paragraph BC57)

(g) Measurement of liabilities. Unlike SFAS 157, which includes limited guidance on the measurement of liabilities, the exposure draft proposes a framework for measuring a liability using the same methodology that the counterparty would use to measure the fair value of a corresponding asset. The FASB is developing a staff position to clarify the measurement of liabilities at fair value in accordance with SFAS 157. If finalised, the proposal is expected to be largely consistent with the proposals in the draft IFRS. (Paragraphs BC67–BC72)

(h) Measurement of equity instruments. Unlike SFAS 157, the exposure draft discusses how to apply the exit price notion to equity instruments measured at fair value.

(i) Wording changes. The IASB staff are preparing a marked-up text showing wording differences between the exposure draft and SFAS 157, as amended. The marked-up text will be made available on the IASB's website.

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Benefits and costs

BC111 The objective of financial statements is to provide information about an entity's financial position, financial performance and cash flows that is useful to a wide range of users for economic decisions. To attain this objective, the Board endeavours to ensure that a proposed IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs to implement a new standard might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

BC112 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the Board considers the following:

(a) the costs incurred by preparers of financial statements;

(b) the costs incurred by users of financial statements when information is not available;

(c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information; and

(d) the benefit of better economic decision-making as a result of improved financial reporting.

BC113 The exposure draft proposes a definition of fair value and a framework for measuring fair value. A single definition of fair value, together with a framework for measuring fair value, should increase consistency in application and, with respect to the resulting fair value measurements, increased comparability.

BC114 The proposed disclosures about fair value measurements would improve the quality of information provided to users of financial statements. Providing information that is useful to a wide range of users in making economic decisions is the objective of financial statements in the *Framework*. In developing the proposed disclosure requirements in the exposure draft, the Board obtained input from users and preparers of financial statements and other interested parties (including members of the Expert Advisory Panel) to ensure that the disclosures would be provided within reasonable cost-benefit constraints.

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BC115 In addition, the exposure draft simplifies the guidance that currently exists for developing fair value measurements, eliminating differences that have added to the complexity in IFRSs.

BC116 Although the framework for measuring fair value builds on current practice and requirements, some methods proposed in the exposure draft may result in a change to practice for some entities. Furthermore, some entities will need to make systems and operational changes, thereby incurring incremental costs. Other entities also might incur incremental costs in applying the proposals. However, the Board believes that the benefits resulting from increased consistency and comparability of fair value information and improved communication of that information to users of financial statements will be ongoing. On balance, the Board concluded that the proposals in the exposure draft will improve financial reporting.

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