Exposure Draft **ED 181**
June 2009

Fair Value Measurement

Comments to AASB by 28 August 2009

Prepared by the
Australian Accounting Standards Board

Australian Government

Australian Accounting Standards Board

Commenting on this AASB Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 28 August 2009. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Respondents to the IASB are asked to send their comments electronically through the 'Open to Comment' page on the IASB website (www.iasb.org)

All non-confidential submissions to the AASB will be made available to the public on the AASB website: www.aasb.gov.au.

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The Customer Service Officer
Australian Accounting Standards Board
Level 7
600 Bourke Street
Melbourne Victoria
AUSTRALIA

Phone: (03) 9617 7637
Fax: (03) 9617 7608
E-mail: publications@aasb.gov.au
Postal address:
PO Box 204
Collins Street West Victoria 8007

Other Enquiries

Phone: (03) 9617 7600
Fax: (03) 9617 7608
E-mail: standard@aasb.gov.au

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AASB REQUEST FOR COMMENTS

In light of the Australian Accounting Standards Board's (AASB's) policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(a) any of the proposals in the attached International Accounting Standards Board (IASB) Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft; and

(b) the 'AASB Specific Matters for Comment' listed below.

The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 28 August 2009. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

AASB Specific Matters for Comment

The AASB would particularly value comments on whether:

(a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

  (i) not-for-profit entities; and

  (ii) public sector entities.

(b) overall, the proposals would result in financial statements that would be useful to users; and

(c) the proposals are in the best interests of the Australian economy.

May 2009

Exposure Draft ED/2009/5

Fair Value Measurement

Comments to be received by 28 September 2009

International
Accounting Standards
Board®

Exposure Draft

FAIR VALUE MEASUREMENT

Comments to be received by 28 September 2009

ED/2009/5

This exposure draft *Fair Value Measurement* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued as an International Financial Reporting Standard (IFRS). Comments on the draft IFRS and its accompanying documents (see separate booklets) 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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IASC Foundation Publications Department,
1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.
Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
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APPROVAL OF *FAIR VALUE MEASUREMENT* BY THE BOARD

BASIS FOR CONCLUSIONS *(see separate booklet)*

ILLUSTRATIVE EXAMPLES *(see separate booklet)*

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Introduction

Reasons for publishing the exposure draft

The proposed IFRS defines fair value, establishes a framework for measuring fair value and requires disclosures about fair value measurements.

IFRSs require some assets, liabilities and equity instruments to be measured at fair value. However, guidance on measuring fair value has been added to IFRSs piecemeal over many years as the International Accounting Standards Board or its predecessor decided that fair value was an appropriate measurement or disclosure basis in a particular situation.

As a result, guidance on measuring fair value is dispersed across many IFRSs and it is not always consistent. Furthermore, the current guidance is incomplete, in that it provides neither a clear measurement objective nor a robust measurement framework. The Board believes that this adds unnecessary complexity to IFRSs and contributes to diversity in practice.

The Board's objectives for publishing the proposed IFRS are:

(a) to establish a single source of guidance for all fair value measurements required or permitted by IFRSs to reduce complexity and improve consistency in their application;

(b) to clarify the definition of fair value and related guidance in order to communicate the measurement objective more clearly; and

(c) to enhance disclosures about fair value to enable users of financial statements to assess the extent to which fair value is used and to inform them about the inputs used to derive those fair values.

The proposed IFRS does not require additional fair value measurements.

Main features of the draft IFRS

The draft IFRS 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).

In the absence of an actual transaction at the measurement date, a fair value measurement assumes a hypothetical transaction in the most advantageous market for the asset or liability.

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A fair value measurement requires an entity to determine:

(a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account).

(b) for an asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).

(c) the most advantageous market for the asset or liability.

(d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use in pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

Invitation to comment

The International Accounting Standards Board invites comments on any aspect of the exposure draft of its proposed IFRS *Fair Value Measurement*. It would particularly welcome answers to the questions set out below. Comments are most helpful if they:

(a) respond to the questions as stated,

(b) indicate the specific paragraph or paragraphs to which the comments relate,

(c) contain a clear rationale, and

(d) describe any other approaches the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.

The Board will consider all comments received in writing by **28 September 2009**. In considering the comments, the Board will base its conclusions on the merits of the arguments for and against each approach, not on the number of responses supporting each approach.

The Board plans to hold public round-table meetings after the comment deadline with selected respondents. Please indicate whether you are interested in taking part in a round-table meeting.

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Definition of fair value and related guidance

Question 1

The exposure draft proposes 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) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs.

Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

Scope

Question 2

In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts:

(a) In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 *Share-based Payment* and reacquired rights in IFRS 3 *Business Combinations*) (see paragraph BC29 of the Basis for Conclusions).

(b) The third context is the requirement in paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement* that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

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The transaction

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?

Question 4

The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions).

Is the description of market participants adequately described in the context of the definition? Why or why not?

Application to assets: highest and best use and valuation premise

Question 5

The exposure draft proposes that:

(a) the fair value of an asset should consider a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).

(b) the highest and best use of an asset establishes the valuation premise, which may be either 'in use' or 'in exchange' (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).

(c) the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

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Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions).

Is the proposed guidance sufficient and appropriate? If not, why?

Application to liabilities: general principles

Question 7

The exposure draft proposes that:

(a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).

(b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).

(c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

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Application to liabilities: non-performance risk and restrictions

Question 8

The exposure draft proposes that:

(a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfil the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).

(b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

Fair value at initial recognition

Question 9

The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions).

Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

Valuation techniques

Question 10

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples).

Is this proposed guidance appropriate and sufficient? Why or why not?

Disclosures

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

Convergence with US GAAP

Question 12

The exposure draft differs from Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157.

Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

Other comments

Question 13

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

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[Draft] International Financial Reporting Standard X *Fair Value Measurement* ([draft] IFRS X) is set out in paragraphs 1–64 and Appendices A–D. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its core principle and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

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[Draft] International Financial Reporting Standard X *Fair Value Measurement*

Core principle

1 ***Fair value*** **is the price that would be received to sell an asset or paid to transfer a liability in an *orderly transaction* between *market participants* at the measurement date.**[*]

Scope

2 This [draft] IFRS applies to IFRSs that require or permit fair value measurements or disclosures, except that it does not replace the requirement in paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement*.[†]

3 This [draft] IFRS explains how to measure fair value. It does not require additional fair value measurements.

Measurement

Fair value

4 The following paragraphs discuss aspects of the core principle:

(a) the asset or liability (paragraphs 5 and 6)

(b) the transaction (paragraphs 7–12)

(c) market participants (paragraphs 13 and 14)

(d) the price (paragraphs 15 and 16)

(e) application to assets (paragraphs 17–24)

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* The core principle focuses on assets and liabilities because they are a primary subject of accounting measurement. However, as discussed in paragraphs 32 and 33, the core principle shall also be applied when measuring the fair value of equity instruments.

† Paragraph 49 of IAS 39 states that the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. In all other respects, an entity shall apply this [draft] IFRS when measuring the fair value of such a liability.

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(f) application to liabilities (paragraphs 25–31)

(g) application to equity instruments (paragraphs 32 and 33).

The asset or liability

5 A fair value measurement is for a particular asset or liability. Therefore, the measurement shall consider the characteristics of the asset or liability (eg the condition and location of the asset and restrictions, if any, on its sale or use) if market participants would consider those characteristics when determining the price for the asset or liability at the measurement date.

6 The asset or liability might be a stand-alone asset or liability (eg a financial instrument or an operating asset) or a group of assets or liabilities (eg a cash-generating unit or a business) depending on the *unit of account* prescribed by IFRSs applicable to the asset or liability or group of assets or liabilities.

The transaction

7 A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (eg a forced liquidation or distress sale).

8 A fair value measurement shall assume that the transaction to sell the asset or transfer the liability takes place in the *most advantageous market* to which the entity has access. The most advantageous market is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering *transaction costs* and *transport costs*.

9 Because different entities (and businesses within those entities) with different activities enter into transactions in different markets, the most advantageous market for the same asset or liability might be different for different entities. Therefore, the most advantageous market (and thus, market participants) shall be considered from the perspective of the reporting entity.

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10 An entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market. The market in which the entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market.

11 In the absence of evidence to the contrary, an entity may assume that the *principal market* for the asset or liability is the most advantageous market, provided that the entity can access the principal market.* The principal market is the market with the greatest volume and level of activity for the asset or liability. Regardless of the market used, an entity shall apply the fair value hierarchy as described in paragraphs 43 and 44.

12 In the absence of an actual transaction to sell the asset or transfer the liability at the measurement date, a fair value measurement assumes a hypothetical transaction at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That hypothetical transaction notion establishes a basis for estimating the price to sell the asset or to transfer the liability. Because the transaction is hypothetical, it is necessary to consider the characteristics of market participants who would enter into a transaction for the asset or liability.

Market participants

13 Market participants are buyers and sellers in the most advantageous market for the asset or liability that are:

(a) independent of each other,† ie they are not related parties (as defined in IAS 24 *Related Party Disclosures*);

(b) knowledgeable, ie they are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability;

(c) able to enter into a transaction for the asset or liability; and

(d) willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.

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* Although an entity must have access to the market at the measurement date, it does not need to be able to sell the particular asset or transfer the particular liability on that date, eg if there is a restriction on the sale of the asset (see paragraphs 46 and 47).

† The reporting entity is a market participant, but it is not the only market participant to consider when measuring fair value.

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14 **The fair value of the asset or liability shall be measured using the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, an entity need not identify specific market participants. Rather, the entity shall identify characteristics that distinguish market participants generally, considering factors specific to:**

(a) the asset or liability,

(b) the most advantageous market for the asset or liability and

(c) market participants with whom the reporting entity would enter into a transaction in that market.

The price

15 Fair value is the price that would be received to sell an asset or paid to transfer a liability in the most advantageous market at the measurement date (an exit price), whether that price is directly observable or estimated using a valuation technique. In the absence of an observable market to provide pricing information, an entity shall consider the characteristics of market participants who would enter into a transaction for the asset or liability.

16 Although transaction costs are considered when determining the most advantageous market, the price used to measure the fair value of the asset or liability shall not be adjusted for those costs.[*] Transaction costs are the incremental direct costs to sell the asset or transfer the liability.[†] Transaction costs are not a characteristic of the asset or liability; rather, they are specific to the transaction and will differ depending on how an entity enters into a transaction for an asset or liability. Transaction costs do not include the costs that would be incurred to transport an asset to or from its most advantageous market. If location is a characteristic of the asset (as might be the case for a commodity), the price in the most advantageous market shall be adjusted for the costs, if any, that would be incurred to transport the asset to or from that market.

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* Transaction costs shall be accounted for in accordance with other relevant IFRSs.

† Incremental costs to sell the asset or transfer the liability refer to those costs that are directly attributable to the disposal of an asset or transfer of a liability. They are essential to that transaction and would not have been incurred by an entity had the decision to sell the asset (or transfer the liability) not been made (similar to costs to sell, as defined in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*).

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Application to assets: highest and best use

17 A fair value measurement considers a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its *highest and best use*. Highest and best use refers to the use of an asset by market participants 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, considering uses of the asset that are physically possible, legally permissible and financially feasible at the measurement date. A use that is:

(a) physically possible takes into account the physical characteristics of the asset that market participants would consider when pricing the asset (eg the location or size of a property).

(b) legally permissible takes into account any legal restrictions on the use of the asset that market participants would consider when pricing the asset (eg the zoning regulations applicable to a property).

(c) financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into consideration the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

18 Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, an entity need not perform an exhaustive search for other potential uses if there is no evidence to suggest that the current use of an asset is not its highest and best use.

19 The highest and best use of an asset acquired in a business combination might differ from the intended use of the asset by the acquirer. For competitive or other reasons, the acquirer may intend not to use an acquired asset actively or it may not intend to use the asset in the same way as other market participants. This might be the case for some acquired intangible assets, eg an acquired trademark that competes with an entity's own trademark. Nevertheless, an entity shall measure the fair value of the asset assuming its highest and best use by market participants.

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20 In some cases, an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset. For example, an entity might operate a factory on a parcel of land even though the highest and best use of the land is to demolish the factory and build residential property. In such cases, the fair value of the asset group has the following components:

(a) the value of the assets assuming their current use. This value differs from fair value when the current use of the assets is not their highest and best use. However, this value reflects all other factors market participants would consider when determining the price for the assets.

(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).

21 An entity shall recognise the incremental value described in paragraph 20(b) together with the asset to which it relates. Using the example in paragraph 20, the incremental value relates to the entity's ability to convert the land from its current use as an industrial property to its highest and best use as a residential property. Accordingly, the fair value of the land comprises its value assuming its current use plus the incremental value described in paragraph 20(b). The amount attributed to the factory reflects its current use as noted in paragraph 20(a). An entity shall account for the assets in accordance with the IFRSs applicable to those assets.

Application to assets: valuation premise

22 The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:

(a) The highest and best use of the asset is 'in use' if the asset would provide maximum value to market participants principally through its use in combination with other assets and liabilities as a group (as installed or otherwise configured for use). If the highest and best use of the asset is in use, the fair value of the asset shall be measured using an *in-use valuation premise*. When using an in-use valuation premise, the fair value of the asset is measured on the basis of the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets and liabilities as a group and that those assets and liabilities (complementary assets and liabilities) would be available to market participants. Assumptions about the highest and best use of the

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asset shall be consistent for all of the assets of the group within which it would be used.

(b) The highest and best use of the asset is 'in exchange' if the asset would provide maximum value to market participants principally on a stand-alone basis. If the highest and best use of the asset is in exchange, the fair value of the asset shall be measured using an *in-exchange valuation premise*. Using an in-exchange valuation premise, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants who would use the asset on a stand-alone basis.

23 Because the highest and best use of the asset is determined on the basis of its use by market participants, fair value reflects the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.* Both the in-use valuation premise and the in-exchange valuation premise assume that the asset is sold individually, ie not as part of a group of assets or a business. However, the in-use valuation premise assumes that market participants will use the asset in combination with other assets or liabilities, and that those assets and liabilities are available to those market participants.

24 An entity shall use an in-exchange valuation premise when measuring the fair value of a financial asset. The fair value of a financial asset determined using the in-exchange valuation premise reflects any benefits that market participants would derive from holding that asset in a diversified portfolio. As a result, the in-use valuation premise is not relevant for financial assets.

Application to liabilities: general principles

25 A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability continues and the market participant transferee would be required to fulfil it; it is not settled with the counterparty or otherwise extinguished).

26 In many cases, there will not be an observable market price for the transfer of a liability. In such cases, an entity shall measure the fair value of a liability using the same methodology that the counterparty would use to measure the fair value of the corresponding asset.

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* The fair value of an asset in use is determined on the basis of the use of the asset together with other assets and liabilities as a group (consistently with its highest and best use from the perspective of market participants), even if the asset is aggregated (or disaggregated) at a different level when applying other IFRSs.

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27 If there is an active market for transactions between parties who hold debt securities as an asset, the observed price in that market also represents the fair value of the issuer's liability. An entity shall adjust the observed price for the asset for features that are present in the asset but not present in the liability, or vice versa. For example, in some cases the observed price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. In such cases, the objective is to estimate the fair value of the issuer's liability, not the price of the combined package. Thus, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement, a feature that is not present in the liability.

28 If there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity shall estimate the price that market participants would demand to assume the liability using present value techniques (see Appendix C) or other valuation techniques (see paragraphs 38–40). When using a present value technique, an entity must, among other things, estimate the future cash outflows that market participants would incur in fulfilling the obligation. An entity may estimate those future cash outflows by:

(a) estimating the cash flows the entity would incur in fulfilling the obligation;

(b) excluding cash flows, if any, that other market participants would not incur; and

(c) including cash flows, if any, that other market participants would incur but the entity would not incur.

Although the technique is based, in part, on a settlement notion (ie cash flows incurred to fulfil the obligation), it produces the same price that would be paid to transfer a liability at the measurement date, provided that technique is applied in a manner consistent with Appendix C. This is because a market participant transferee would assume the same obligation to fulfil the liability. An entity need not undertake exhaustive efforts to determine the cash flows in (b) and (c) above. However, an entity shall not ignore information about market participant assumptions that is reasonably available.

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Application to liabilities: non-performance risk

29 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 risk is assumed to be the same before and after the transfer of the liability. This is because market participants would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price. For example, a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor (debtor) if those terms reflect the transferor's lower credit standing.

30 Non-performance risk includes, but may not be limited to, an entity's own credit risk. When measuring the fair value of a liability, an entity shall consider the effect of its credit risk (credit standing) and any other risk factors that might influence the likelihood that the obligation will not be fulfilled. That effect may differ depending on the liability, eg whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability), and the terms of credit enhancements related to the liability, if any.

Application to liabilities: restrictions

31 A restriction on an entity's ability to transfer a liability to another party does not affect the fair value of the liability. This is because the fair value of a liability is a function of the requirement to fulfil the obligation. A market participant transferee would be required to fulfil the obligation and would take that into account when determining the price it would demand to assume the liability from the entity.[*]

Application to equity instruments

32 As with assets and liabilities, the objective of a fair value measurement of an equity instrument is to estimate an exit price at the measurement date.

[*] Because the transfer is hypothetical, it is necessary to consider the characteristics of market participants who would enter into a transaction for the liability.

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33 However, although the objective is the same, the issuer of an equity instrument can exit from that instrument only if the instrument ceases to exist or if the entity repurchases the instrument from the holder. For this reason, an entity shall measure the fair value of its equity instrument from the perspective of a market participant who holds the instrument as an asset.

Fair value at initial recognition

34 When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (often referred to as an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them. In some cases, eg in a business combination, there is not a transaction price for each individual asset or liability. Likewise, sometimes there is not an exchange transaction for the asset or liability, eg when biological assets regenerate.

35 Although conceptually entry prices and exit prices are different, in many cases an entry price of an asset or liability will equal the exit price (eg when on the transaction date the transaction to buy an asset would take place in the market in which the asset would be sold). In such cases, the fair value of an asset or liability at initial recognition equals the entry (transaction) price.

36 In determining whether fair value at initial recognition equals the transaction price, an entity shall consider factors specific to the transaction and the asset or liability. For example, the transaction price is the best evidence of the fair value of an asset or liability at initial recognition unless:

(a) the transaction is between related parties.

(b) the transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

(c) the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges

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that are separately measured or the transaction price includes transaction costs.

(d) the market in which the transaction takes place is different from the market in which the entity would sell the asset or transfer the liability, ie the most advantageous market. For example, those markets might be different if the entity is a securities dealer that transacts in different markets with retail customers (retail market) and with other securities dealers (inter-dealer market).

37 If an IFRS requires or permits an entity to measure an asset or liability initially at fair value and the transaction price differs from fair value, the entity recognises the resulting gain or loss in profit or loss unless the IFRS requires otherwise.

Valuation techniques

38 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. Valuation techniques consistent with the market approach, income approach or cost approach shall be used to measure fair value. The main aspects of those approaches are summarised below:

(a) The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering factors (qualitative and quantitative) specific to the measurement. Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but relying on the securities' relationship to other benchmark quoted securities.

(b) The income approach uses valuation techniques to convert future amounts (eg cash flows or income and expenses) to a single present (discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques (see Appendix C); option pricing models,

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such as the Black-Scholes-Merton formula (a closed form model) and a binomial model (a lattice model), which incorporate present value techniques and reflect both the time value and intrinsic value of an option; and the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

(c) The cost approach reflects the amount that would currently be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence, and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives). The current replacement cost approach is generally appropriate for measuring the fair value of tangible assets using an in-use valuation premise because a market participant would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

39 An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs. Periodically, an entity shall calibrate the valuation technique(s) used to prices from observable current market transactions in the same asset or liability (at initial recognition, this might be the transaction price). In some cases, a single valuation technique will be appropriate (eg when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (eg as might be the case when valuing a cash-generating unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

40 Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (eg a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That

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might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Inputs to valuation techniques

41 In this [draft] IFRS, 'inputs' refer broadly to the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, eg the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:

(a) *Observable inputs* are inputs that are developed on the basis of available market data and reflect the assumptions that market participants would use when pricing the asset or liability.

(b) *Unobservable inputs* are inputs for which market data are not available and that are developed on the basis of the best information available about the assumptions that market participants would use when pricing the asset or liability.

42 Valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs. In some cases an entity may determine that observable inputs require significant adjustment based on unobservable data and thus the fair value measurement would be categorised in a lower level of the fair value hierarchy. For example, the entity may determine that an income approach valuation technique that maximises the use of relevant observable inputs and minimises the use of unobservable inputs is equally representative of fair value as (or more representative of fair value than) a market approach valuation technique that would require significant adjustments using unobservable inputs.

Fair value hierarchy

43 To increase consistency and comparability in fair value measurements and the related disclosures, this [draft] IFRS establishes a fair value hierarchy that prioritises into three levels (see paragraphs 45–54) the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in

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active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs). In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised in different levels of the fair value hierarchy. The 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. Assessing the significance of a particular input to the entire measurement requires judgement, considering factors specific to the asset or liability.

44 The availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level in the fair value hierarchy within which those inputs are categorised. If observable inputs require significant adjustment using unobservable inputs, the resulting measurement is a Level 3 measurement.

Level 1 inputs

45 *Level 1 inputs* are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

46 Although an entity must have access to the market at the measurement date, it does not need to be able to sell the particular asset or transfer the particular liability on that date, eg if there is a restriction on the sale of the asset. However, the entity must be able to access the market when the restriction ceases to exist.

47 If a market participant would consider a restriction on the sale of an asset when determining the price for the asset, an entity shall adjust the quoted price to reflect the effect of that restriction. Such an adjustment is not a Level 1 input and, if the adjustment is significant, the measurement would be categorised in a lower level of the fair value hierarchy.

48 An active market for the asset or liability is 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. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 49 and 50.

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49 If an entity holds a large number of similar assets or liabilities (eg debt securities) that are measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, as a practical expedient, an entity may measure fair value using an alternative pricing method that does not rely exclusively on quoted prices (eg matrix pricing). However, the use of an alternative pricing method results in a lower level fair value measurement.

50 In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades or announcements) take place after the close of a market but before the measurement date. An entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment results in a lower level fair value measurement.

Level 2 inputs

51 *Level 2 inputs* are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices). If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

(a) quoted prices for similar assets or liabilities in active markets

(b) quoted prices for identical or similar assets or liabilities in markets that are not active (paragraph B5 provides examples of factors that may indicate that a market is not active)

(c) inputs other than quoted prices that are observable for the asset or liability (eg interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks and default rates)

(d) inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

52 Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition or location of the asset, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity

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in the markets within which the inputs are observed. An adjustment that is significant to the entire measurement might result in a Level 3 measurement, depending on where the inputs used to determine the adjustment are categorised in the fair value hierarchy.

Level 3 inputs

53 *Level 3 inputs* are inputs for the asset or liability that are not based on observable market data (unobservable inputs). Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, ie an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

54 Unobservable inputs shall be developed using the best information available in the circumstances, which might include an entity's own data. In developing unobservable inputs, an entity may begin with its own data, which shall be adjusted if reasonably available information indicates that (a) other market participants would use different data or (b) there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy), and the entity is able to quantify these adjustments. An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall not ignore information about market participant assumptions that is reasonably available.

Inputs based on bid and ask prices

55 If an input used to measure fair value is based on bid and ask prices (eg in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where the input is categorised in the fair value hierarchy (Level 1, 2 or 3). This [draft] IFRS does not preclude the use of mid-market pricing or other pricing conventions used by market participants as a practical expedient for fair value measurements within a bid-ask spread. If a bid-ask spread for an asset or a liability is not observable directly or indirectly (eg a bid-ask spread for a similar asset or liability), an entity need not undertake exhaustive efforts to estimate a bid-ask spread.

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56 **For assets and liabilities measured at fair value, an entity shall disclose information that enables users of its financial statements to assess the methods and inputs used to develop those measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.**

57 To meet the objectives in paragraph 56, an entity shall (except as otherwise specified below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, how much aggregation or disaggregation to undertake, and whether users need any additional information to evaluate the quantitative information disclosed. At a minimum, an entity shall disclose the following information for each class of assets and liabilities:

(a) the fair value measurement at the end of the reporting period.

(b) the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).

(c) for assets and liabilities held at the reporting date, any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level shall be disclosed and discussed separately from transfers out of each level. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.

(d) the methods and the inputs used in the fair value measurement and the information used to develop those inputs. If there has been a change in valuation technique (eg changing from a market approach to an income approach), the entity shall disclose that change, the reasons for making it, and its effect on the fair value measurement.

(e) for fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:

(i) total gains or losses for the period recognised in profit or loss, and a description of where they are presented in the statement of comprehensive income or the separate income statement (if presented).

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(ii) total gains or losses for the period recognised in other comprehensive income.

(iii) purchases, sales, issues and settlements (each of those types of change disclosed separately).

(iv) transfers into or out of Level 3 (eg transfers attributable to changes in the observability of market data) and the reasons for those transfers. For significant transfers, transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.

(f) the amount of the total gains or losses for the period in (e)(i) above included in profit or loss that are attributable to gains or losses relating to those assets and liabilities held at the reporting date, and a description of where those gains or losses are presented in the statement of comprehensive income or the separate income statement (if presented).

(g) for fair value measurements categorised within Level 3 of the fair value hierarchy, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes. An entity shall disclose how it calculated those changes. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.

58 For each class of assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed, an entity shall disclose the fair value by the level of the fair value hierarchy.

59 For each class of liability measured at fair value after initial recognition, an entity shall disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the liability that is attributable to changes in the non-performance risk of that liability, and the reasons for that change.

(b) how the entity estimated the amount in paragraph 59(a) attributable to changes in the non-performance risk of the liability.

(c) the difference between the liability's carrying amount and the amount of economic benefits the entity is required to sacrifice to

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satisfy the obligation (eg for a contractual liability, this would be the amount the entity is contractually required to pay to the holder of the obligation).

60 If an asset is used together with other assets and its highest and best use differs from its current use (see paragraphs 20 and 21), an entity shall disclose, by class of asset:

(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).

(c) the reasons the assets are being used in a manner that differs from their highest and best use.

61 An entity shall present the quantitative disclosures required by this [draft] IFRS in a tabular format unless another format is more appropriate.

Effective date and transition

62 A entity shall apply this [draft] IFRS for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies the [draft] IFRS for an earlier period, it shall disclose that fact.

63 This [draft] IFRS shall be applied prospectively as of the beginning of the annual period in which it is initially applied.

64 The disclosure requirements of this [draft] IFRS need not be applied in comparative information provided for periods before initial application of the [draft] IFRS.

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Appendix A
Defined terms

This appendix is an integral part of the [draft] IFRS.

active market	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.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
highest and best use	The use of an asset by market participants 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.
International Financial Reporting Standards (IFRSs)	Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise: (a) International Financial Reporting Standards; (b) International Accounting Standards; and (c) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).
in-exchange valuation premise	A basis used to determine the fair value of an asset that provides maximum value to market participants principally on a stand-alone basis.
in-use valuation premise	A basis used to determine the fair value of an asset that provides maximum value to market participants principally through its use in combination with other assets and liabilities as a group (as installed or otherwise configured for use).
Level 1 inputs	Quoted prices (unadjusted) in active markets for identical assets or liabilities.

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Level 2 inputs Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices).

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

market participants Buyers and sellers in the most advantageous market for the asset or liability that are:

(a) independent of each other, ie they are not related parties as defined in IAS 24 *Related Party Disclosures*;

(b) knowledgeable, ie they are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability;

(c) able to enter into a transaction for the asset or liability; and

(d) willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.

most advantageous market The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs.

non-performance risk The risk that an entity will not fulfil an obligation.

observable inputs Inputs that are developed on the basis of available market data and reflect the assumptions that market participants would use when pricing the asset or liability.

orderly transaction A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (eg a forced liquidation or distress sale).

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principal market	The market with the greatest volume and level of activity for the asset or liability.
transport costs	The costs that would be incurred to transport an asset to or from its most advantageous market.
unit of account	The level at which an asset or liability is aggregated or disaggregated in IFRSs.
unobservable inputs	Inputs for which market data are not available and that are developed on the basis of the best information available about the assumptions that market participants would use when pricing the asset or liability.

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Appendix B
Application guidance

This appendix is an integral part of the [draft] IFRS.

The fair value measurement approach

B1 The objective of a fair value measurement is to determine the price that would be received to sell an asset or paid to transfer a liability at the measurement date. A fair value measurement requires an entity to determine:

(a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account).

(b) for an asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).

(c) the most advantageous market for the asset or liability.

(d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use in pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

In-use valuation premise

B2 When measuring the fair value of a non-financial asset in use, the effect of using an in-use valuation premise depends on the circumstances. For example:

(a) the fair value of the asset might be the same whether using an in-use or an in-exchange valuation premise. That might be the case if the asset is a business that market participants would continue to operate. In that case, the transaction would involve the business in its entirety. The use of the assets as a group in an ongoing business would generate synergies that would be available to market participants (market participant synergies).

(b) the in-use valuation premise might be incorporated in the fair value of the asset through adjustments to the value of the asset 'in exchange'. That might be the case if the asset is a machine and the fair value measurement is determined using an observed price for a similar machine (not installed or otherwise configured for

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use), adjusted for transport and installation costs so that the fair value measurement reflects the current condition and location of the machine (installed and configured for use).

(c) the in-use valuation premise might be incorporated into the fair value of the asset through the market participant assumptions used to measure the fair value of the asset. For example, if the asset is work-in-progress inventory that is unique and market participants would convert the inventory into finished goods, the fair value of the inventory would assume that market participants have or would acquire any specialised machinery necessary to convert the inventory into finished goods.

(d) the in-use valuation premise might be incorporated into the valuation technique used to measure the fair value of the asset. That might be the case when using the multi-period excess earnings method to measure the fair value of some intangible assets because that valuation technique specifically considers the contribution of any complementary assets in the group in which such an intangible asset would be used.

(e) in more limited situations, when an entity uses an asset within a group of assets, the entity might measure the asset at an amount that approximates its fair value in use when allocating the fair value of the asset group to the individual assets of the group. That might be the case if the valuation involves real property and the fair value of improved property (an asset group) is allocated to its component assets (such as land and improvements).

Fair value hierarchy

Level 2 input

B3 Examples of Level 2 inputs for particular assets and liabilities follow.

(a) *Receive-fixed, pay-variable interest rate swap based on the LIBOR swap rate*. A Level 2 input would include the LIBOR swap rate if that rate is observable at commonly quoted intervals for the full term of the swap.

(b) *Receive-fixed, pay-variable interest rate swap based on a foreign-denominated yield curve*. A Level 2 input would include the swap rate based on a foreign-denominated yield curve that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is

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observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for year 10 would not be significant to the fair value measurement of the swap in its entirety.

(c) *Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate*. A Level 2 input would include the bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.

(d) *Three-year option on exchange-traded shares*. A Level 2 input would include the implied volatility for the shares derived through extrapolation to year 3 if (i) prices for one-year and two-year options on the shares are observable and (ii) the extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option. In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one-year and two-year implied volatilities is established.

(e) *Licensing arrangement*. For a licensing arrangement that is acquired in a business combination and was recently negotiated with an unrelated party by the acquired entity (the party to the licensing arrangement), a Level 2 input would include the royalty rate at inception of the arrangement.

(f) *Finished goods inventory at a retail outlet*. For finished goods inventory that is acquired in a business combination, a Level 2 input would include either a price to customers in a retail market or a wholesale price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments shall be used for the fair value measurement.

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(g) *Building held and used*. A Level 2 input would include the price per square metre for the building (a valuation multiple) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (similar) buildings in similar locations.

(h) *Cash-generating unit*. A Level 2 input would include a valuation multiple (eg a multiple of earnings or revenue or a similar performance measure) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (similar) businesses, considering operational, market, financial and non-financial factors.

Level 3 inputs

B4 Examples of Level 3 inputs for particular assets and liabilities follow.

(a) *Long-dated currency swap*. A Level 3 input would include interest rates in a specified currency that are not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.

(b) *Three-year option on exchange-traded shares*. A Level 3 input would include historical volatility, ie the volatility for the shares derived from the shares' historical prices. Historical volatility typically does not represent current market participant expectations about future volatility, even if it is the only information available to price an option.

(c) *Interest rate swap*. A Level 3 input would include an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.

(d) *Decommissioning liability assumed in a business combination*. A Level 3 input would include a current estimate of the cash outflows to be paid to fulfil the obligation developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions. That Level 3 input would be used in a present value technique together with other inputs, eg (i) a current risk-free discount rate that adjusts the estimated future cash outflows for the time value of money or a credit-adjusted risk-free rate if the effect of the entity's credit

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standing on the fair value of the liability is reflected in the discount rate rather than in the estimate of future cash outflows and (ii) an estimate of the premium, if any, that market participants would require for bearing risk arising from the obligation (the risk premium) and to generate the profit they would require for undertaking to fulfil the obligation. The risk premium takes into account the uncertainty inherent in the estimate of the future cash outflows (ie the price market participants would require for bearing the risk of possible variations in the amount or timing of the cash flows).

(e) *Cash-generating unit*. A Level 3 input would include a financial forecast (eg of cash flows or profit or loss) developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions.

Not active markets and transactions that are not orderly

B5 The presence of the following factors may indicate that a market is not active:

(a) there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities).

(b) there are few recent transactions.

(c) price quotations are not based on current information.

(d) price quotations vary substantially over time or among market-makers (eg some brokered markets).

(e) indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

(f) there is a significant increase in implied liquidity risk premiums, yields or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the entity's estimate of expected cash flows, considering all available market data about credit and other non-performance risk for the asset or liability.

(g) there is a wide bid-ask spread or significant increase in the bid-ask spread.

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(h) there is a significant decline or absence of a market for new issues (ie primary market) for the asset or liability (or similar assets or liabilities).

(i) little information is released publicly (eg a principal-to-principal market).

An entity evaluates the significance and relevance of the factors (together with other pertinent factors) to determine whether, on the basis of the evidence available, a market is not active.

B6 If an entity concludes that a market is not active, transactions or quoted prices in that market may not be determinative of fair value (eg there may be transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to measure fair value. Significant adjustments also may be necessary in other circumstances (eg when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

B7 This [draft] IFRS does not prescribe a methodology for making significant adjustments to transactions or quoted prices. Paragraphs 38–40 discuss the use of valuation techniques when measuring fair value. Regardless of the valuation technique used, an entity includes appropriate risk adjustments, including a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) inherent in the cash flows of an asset or liability (see paragraph C5). Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment. The risk premium should be reflective of an orderly transaction between market participants at the measurement date under current market conditions.

B8 If a market is not active, a change in valuation technique or the use of multiple valuation techniques may be appropriate (eg the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, an entity considers the reasonableness of the range of fair value estimates. The objective is to determine the point within the range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

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B9 Even when a market is not active, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (ie not a forced liquidation or distress sale) between market participants at the measurement date under current market conditions.

B10 Measuring fair value in a market that is not active depends on the facts and circumstances and requires the use of significant judgement. An entity's intention to continue to hold the asset or liability is not relevant when measuring fair value because fair value is a market-based measurement, not an entity-specific measurement.

B11 Even if a market is not active, it is not appropriate to conclude that all transactions in that market are not orderly (ie are forced or distress sales). Circumstances that may indicate that a transaction is not orderly include, but are not limited to the following:

(a) there was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

(b) there was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

(c) the seller is in or near bankruptcy or receivership (ie distressed) or the seller was required to sell to meet regulatory or legal requirements (ie forced).

(d) the transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

An entity evaluates the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly.

B12 If the evidence indicates that a transaction is not orderly, an entity places little, if any, weight (compared with other indications of fair value) on that transaction price when measuring fair value or estimating market risk premiums.

B13 If the evidence indicates that a transaction is orderly, an entity considers that transaction price when measuring fair value or estimating market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the size of the transaction, the comparability of the transaction to the asset or liability being measured and the proximity of the transaction to the measurement date.

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B14 If an entity does not have sufficient information to conclude whether a transaction is orderly, it considers the transaction price when measuring fair value or estimating market risk premiums. However, that transaction price may not be determinative of fair value (ie the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When an entity does not have sufficient information to conclude whether particular transactions are orderly, the entity places less weight on those transactions.

B15 An entity need not undertake exhaustive efforts to determine whether a transaction is orderly but it shall not ignore information that is reasonably available. When an entity is a party to a transaction it is presumed to have sufficient information to conclude whether the transaction is orderly.

Quoted prices provided by third parties

B16 When an entity is measuring fair value, this [draft] IFRS does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the entity has determined that the quoted prices provided by those parties are determined in accordance with this [draft] IFRS.

B17 If a market is not active, an entity must evaluate whether the quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, an entity places less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions.

B18 Furthermore, the nature of a quote (eg whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

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Appendix C
Present value techniques

This appendix is an integral part of the [draft] IFRS.

Introduction

C1 This appendix provides information about using present value techniques to measure fair value. This guidance focuses on a traditional or discount rate adjustment technique and an expected cash flow (expected present value) technique. This guidance neither prescribes the use of one specific present value technique nor limits the use of present value techniques to measure fair value to the techniques discussed. The present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (eg whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data.

The components of a present value measurement

C2 Present value (an application of the income approach) is a tool used to link uncertain future amounts (cash flows or values) to a present amount using a discount rate that is consistent with value maximising behaviour. A fair value measurement of an asset or liability, using present value, shall capture the following elements from the perspective of market participants at the measurement date:

(a) an estimate of future cash flows for the asset or liability being measured

(b) expectations about possible variations in the amount and/or timing of the cash flows representing the uncertainty inherent in the cash flows

(c) the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (risk-free interest rate)

(d) the price for bearing the uncertainty inherent in the cash flows (risk premium)

(e) other factors that would be considered by market participants in the circumstances.

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General principles

C3 Present value techniques differ in how they capture those elements. However, the following general principles govern the application of any present value technique used to estimate fair value:

(a) Cash flows and discount rates shall reflect assumptions that market participants would use when pricing the asset or liability.

(b) Cash flows and discount rates shall consider only the features of the asset or liability being measured.

(c) To avoid double-counting or omitting the effects of risk factors, discount rates shall reflect assumptions that are consistent with those inherent in the cash flows.*

(d) Assumptions about cash flows and discount rates shall be internally consistent. For example, nominal cash flows (that include the effect of inflation) shall be discounted at a rate that includes the effect of inflation. The nominal risk-free interest rate includes the effect of inflation. Real cash flows (that exclude the effect of inflation) shall be discounted at a rate that excludes the effect of inflation. Similarly, after-tax cash flows shall be discounted using an after-tax discount rate. Pre-tax cash flows shall be discounted at a rate consistent with those cash flows.

(e) Discount rates shall be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

Risk and uncertainty

C4 A fair value measurement, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, both the amount and timing of the cash flows will be uncertain. Even contractually fixed amounts, such as the payments on a loan, will be uncertain if there is risk of default.

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* For example, a discount rate that reflects expectations about future defaults is appropriate if using contractual cash flows of a loan (discount rate adjustment technique). That same rate would not be used if using expected (probability-weighted) cash flows (expected present value technique) because the expected cash flows already reflect assumptions about future defaults; instead, a discount rate that is commensurate with the risk inherent in the expected cash flows shall be used.

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C5 Risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement shall include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not sufficient reason to exclude a risk adjustment.

C6 Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example:

(a) the discount rate adjustment technique (see paragraphs C7–C11) uses contractual, promised or most likely cash flows and a discount rate that includes an adjustment for both (i) the effect of the difference between those cash flows and the expected cash flows and (ii) the risk premium that market participants require for bearing the risk that the actual cash flows may ultimately differ from the expected cash flows.

(b) Method 1 of the expected present value technique (see paragraph C14) uses risk-adjusted expected cash flows and a risk-free rate.

(c) Method 2 of the expected present value technique (see paragraph C15) uses expected cash flows and a discount rate adjusted to include the risk premium that market participants require (this rate is different from the rate used in the discount rate adjustment technique).

Discount rate adjustment technique

C7 The discount rate adjustment technique uses a single set of cash flows from the range of possible estimated amounts, whether contractual or promised (as is the case for a bond) or most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events (eg contractual or promised cash flows for a bond are conditional on the event of no default by the debtor). The discount rate used in the discount rate adjustment technique is derived from observed rates of return for comparable assets or liabilities that are traded in the market. Accordingly, the contractual, promised or most likely cash flows are discounted at an observed or estimated market rate for such conditional cash flows (market rate of return).

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C8 The discount rate adjustment technique requires an analysis of market data for comparable assets or liabilities. Comparability is established by considering the nature of the cash flows (eg whether the cash flows are contractual or non-contractual and are likely to respond similarly to changes in economic conditions), as well as other factors (eg credit standing, collateral, duration, restrictive covenants and liquidity). Alternatively, if a single comparable asset or liability does not fairly reflect the risk inherent in the cash flows of the asset or liability being measured, it may be possible to derive a discount rate using data for several comparable assets or liabilities in conjunction with the risk-free yield curve (a 'build-up' approach).

C9 To illustrate a build-up approach, assume that Asset A is a contractual right to receive CU800* in one year (no timing uncertainty). There is an established market for comparable assets, and information about those assets, including price information, is available. Of those comparable assets:

(a) Asset B is a contractual right to receive CU1,200 in one year and has a market price of CU1,083. Thus, the implied annual rate of return (one-year market rate of return) is 10.8 per cent [(CU1,200/CU1,083) − 1].

(b) Asset C is a contractual right to receive CU700 in two years and has a market price of CU566. Thus, the implied annual rate of return (two-year market rate of return) is 11.2 per cent [(CU700/CU566)^0.5 − 1].

(c) All three assets are comparable as regards risk (dispersion of possible pay-offs and credit).

C10 On the basis of the timing of the contractual payments to be received for Asset A (one year for Asset B versus two years for Asset C), Asset B is deemed more comparable to Asset A. Using the contractual payment to be received for Asset A (CU800) and the one-year market rate derived from Asset B (10.8 per cent), the fair value of Asset A is CU722 (CU800/1.108). Alternatively, in the absence of available market information for Asset B, the one-year market rate could be derived from Asset C using the build-up approach. In that case, the two-year market rate indicated by Asset C (11.2 per cent) would be adjusted to a one-year market rate using the term structure of the risk-free yield curve. Additional information and analysis

* In this [draft] IFRS monetary amounts are denominated in 'currency units (CU)'

might also be required to determine whether the risk premium for one-year and two-year assets is the same. If it is determined that the risk premium for one-year and two-year assets is not the same, the two-year market rate of return would be further adjusted for that effect.

C11 In applying the discount rate adjustment technique to fixed claims, the adjustment for risk inherent in the cash flows of the asset or liability being measured is included in the discount rate. In some applications of the discount rate adjustment technique to cash flows that are not fixed claims, an adjustment to the cash flows also may be necessary to achieve comparability with the observed asset or liability from which the discount rate is derived.

Expected present value technique

C12 The expected present value technique uses as a starting point a set of cash flows that, in theory, represents the probability-weighted average of all possible cash flows (expected cash flows). The resulting estimate is identical to expected value, which, in statistical terms, is the weighted average of a random variable's possible values where the respective probabilities are used as weights. Because all possible cash flows are probability-weighted, the resulting expected cash flow is not conditional upon the occurrence of any specified event (unlike the cash flows used in the discount rate adjustment technique).

C13 In making an investment decision, risk-averse market participants would consider the risk that the actual cash flows may ultimately differ from the expected cash flows. Portfolio theory distinguishes between two types of risk. The first is risk specific to a particular asset or liability, also referred to as unsystematic (diversifiable) risk. The second is general market risk, also referred to as systematic (non-diversifiable) risk. The systematic or non-diversifiable risk of an asset (or liability) refers to the amount by which the asset (or liability) increases the variance of a diversified portfolio when it is added to that portfolio. Portfolio theory holds that in a market in equilibrium, market participants will be compensated only for bearing the systematic or non-diversifiable risk inherent in the cash flows. (In markets that are inefficient or out of equilibrium, other forms of return or compensation might be available.)

C14 Method 1 of the expected present value technique adjusts the expected cash flows for the systematic (market) risk by subtracting a cash risk premium (risk-adjusted expected cash flows). These risk-adjusted expected cash flows represent a certainty-equivalent cash flow, which is discounted at a risk-free interest rate. A certainty-equivalent cash flow

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refers to an expected cash flow (as defined), adjusted for risk so that a market participant is indifferent to trading a certain cash flow for an expected cash flow. For example, if a market participant were willing to trade an expected cash flow of CU1,200 for a certain cash flow of CU1,000, the CU1,000 is the certainty equivalent of the CU1,200 (the CU200 would represent the cash risk premium). In that case, the market participant would be indifferent as to the asset held.

C15 In contrast, Method 2 of the expected present value technique adjusts for systematic (market) risk by adding a risk premium to the risk-free interest rate. Accordingly, the expected cash flows are discounted at a rate that corresponds to an expected rate associated with probability-weighted cash flows (expected rate of return). Models used for pricing risky assets, such as the Capital Asset Pricing Model, can be used to estimate the expected rate of return. Because the discount rate used in the discount rate adjustment technique is a rate of return relating to conditional cash flows, it is likely to be higher than the discount rate used in Method 2 of the expected present value technique, which is an expected rate of return relating to expected or probability-weighted cash flows.

C16 To illustrate Methods 1 and 2, assume that an asset has expected cash flows of CU780 in one year based on the possible cash flows and probabilities shown below. The applicable risk-free interest rate for cash flows with a one-year horizon is 5 per cent, and the systematic risk premium for an asset with the same risk profile is 3 per cent.

Possible cash flows	Probability	Probability-weighted cash flows
CU500	15%	CU75
CU800	60%	CU480
CU900	25%	CU225
Expected cash flows		CU780

C17 In this simple illustration, the expected cash flows (CU780) represent the probability-weighted average of the three possible outcomes. In more realistic situations, there could be many possible outcomes. However, it is not always necessary to consider distributions of literally all possible cash flows using complex models and techniques to apply the expected present value technique. Rather, it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows. For example, an entity might use realised cash flows for some relevant past period, adjusted for changes in

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circumstances occurring subsequently (eg changes in external factors, including economic or market conditions, industry trends and competition as well as changes in internal factors affecting the entity more specifically), considering the assumptions of market participants.

C18 In theory, the present value (fair value) of the asset's cash flows is the same (CU722) whether determined under Method 1 or Method 2, as indicated below. Specifically:

(a) under Method 1, the expected cash flows are adjusted for systematic (market) risk. In the absence of market data directly indicating the amount of the risk adjustment, such adjustment could be derived from an asset pricing model using the concept of certainty equivalents. For example, the risk adjustment (cash risk premium of CU22) could be determined using the systematic risk premium of 3 per cent (CU780 − [CU780 × (1.05/1.08)]), which results in risk-adjusted expected cash flows of CU758 (CU780 − CU22). The CU758 is the certainty equivalent of CU780 and is discounted at the risk-free interest rate (5 per cent). The present value (fair value) of the asset is CU722 (CU758/1.05).

(b) under Method 2, the expected cash flows are not adjusted for systematic (market) risk. Rather, the adjustment for that risk is included in the discount rate. Thus, the expected cash flows are discounted at an expected rate of return of 8 per cent (the 5 per cent risk-free interest rate plus the 3 per cent systematic risk premium). The present value (fair value) of the asset is CU722 (CU780/1.08).

C19 When using an expected present value technique to measure fair value, either Method 1 or Method 2 could be used. The selection of Method 1 or Method 2 will depend on facts and circumstances specific to the asset or liability being measured, the extent to which sufficient data are available and the judgements applied.

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Appendix D
Amendments to other IFRSs

The amendments in this [draft] appendix shall be applied for annual periods beginning on or after [date to be inserted after the exposure period]. If an entity applies this [draft] IFRS for an earlier period, it shall apply these amendments for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

Change in definition

D1 In IFRSs 1 and 3–5 and IASs 2, 16–21, 32 and 39–41 the definition of *fair value* is replaced with:

> *Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See [draft] IFRS X *Fair Value Measurement*.)

D2 In IAS 36 the definition of *fair value less costs to sell* is replaced with:

> *Fair value less costs to sell* is the price that would be received to sell an asset or cash-generating unit in an orderly transaction between market participants at the measurement date, less the costs of disposal.

D3 In IAS 38 the definition of *fair value of an asset* is replaced with the definition of *fair value* as described above.

IFRS 2 *Share-based Payment*

D4 In the Introduction and the IFRS all instances of the term *fair value* are replaced with the term *market-based value*.

D5 The definition of fair value is deleted and the following definition is added:

> *Market-based value* is the price that would be received or paid to sell an asset, transfer a liability, or exchange an equity instrument, in an orderly transaction between market participants at the measurement date, not taking into account market participants' assumptions for vesting conditions and reload features.

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D6 As a consequence, in the following paragraphs of other IFRSs *fair value* is replaced with references to *market-based value*:

IFRS 1	Paragraph D2
IAS 33	Paragraph 47A, Example 5A

IFRS 3 *Business Combinations* (as revised in 2008)

D7 Paragraph 29 is amended as follows:

29 The acquirer shall measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract, even if ~~regardless of whether~~ market participants would consider potential ~~contractual~~ renewals of the contract in determining its ~~fair~~ value. Paragraphs B35 and B36 provide related application guidance.

D8 Paragraph 30 is amended as follows:

30 The acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards with share-based payment awards of the acquirer in accordance with the method in IFRS 2 *Share-based Payment*. ~~(This IFRS refers to the result of that method as the 'market-based measure' of the award.)~~

D9 In Appendix B paragraphs B43 and B46 are amended as follows:

B43 For competitive or other reasons, the acquirer may intend not to use an acquired asset, for example, a research and development intangible asset, or it may intend to use the asset in a way that is different from the way in which other market participants would use it. Nevertheless, the acquirer shall measure the asset in accordance with [draft] IFRS X ~~at fair value determined in accordance with its use by other market participants.~~ reflecting its highest and best use in accordance with the appropriate valuation premise, both initially and when determining fair value less cost to sell for subsequent impairment testing.

B46 In a business combination achieved without the transfer of consideration, the acquirer must substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase (see paragraphs 32–34). ~~The acquirer should measure the acquisition-date fair value of its interest in the~~

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~~acquiree using one or more valuation techniques that are appropriate in the circumstances and for which sufficient data are available. If more than one valuation technique is used, the acquirer should evaluate the results of the techniques, considering the relevance and reliability of the inputs used and the extent of the available data.~~ The acquirer shall determine the acquisition-date fair value of its investment in the acquiree in accordance with [draft] IFRS X.

IFRS 7 *Financial Instruments: Disclosures*

D10 Paragraphs 27–27B are deleted.

D11 Paragraph 28 is amended as follows:

28 ~~If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG74–AG79 of IAS 39). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (ie the fair value of the consideration given or received), unless conditions described in paragraph AG76 of IAS 39 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:~~ In some cases, an entity does not recognise a gain or loss on initial recognition of a financial asset or financial liability because the fair value is neither evidenced by observable current market transactions in the same instrument (ie without modification or repackaging) nor based on a valuation technique whose variables include only data from observable markets (see paragraph AG76 of IAS 39). In such cases, the entity shall disclose by class of financial asset or financial liability:

(a) its accounting policy for recognising the~~at~~ difference between the fair value at initial recognition and the transaction price in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph AG76(b) of IAS 39).~~; and~~

(b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference. This disclosure should be made by level in the fair value hierarchy in which the fair value measurement is categorised.

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(c) the reason(s) why the entity determined that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value.

D12 Paragraph 28A is added:

28A When an entity recognises a gain or loss on initial recognition of a financial asset or financial liability at a fair value that differs from the transaction price (see paragraph AG76 of IAS 39), the entity shall disclose the gain or loss separately for each class of financial asset or financial liability by the level in the fair value hierarchy in which the fair value measurement is categorised.

IAS 1 *Presentation of Financial Statements*

D13 In IAS 1, paragraph 133 is amended as follows:

133 Other IFRSs require the disclosure of some of the assumptions that would otherwise be required in accordance with paragraph 125. For example, IAS 37 requires disclosure, in specified circumstances, of major assumptions concerning future events affecting classes of provisions. [Draft] IFRS ~~7~~ *X Fair Value Measurement* requires disclosure of significant assumptions the entity uses in estimating the fair values of ~~financial~~ assets and ~~financial~~ liabilities that are carried at fair value. ~~IAS 16 requires disclosure of significant assumptions that the entity uses in estimating the fair values of revalued items of property, plant and equipment.~~

IAS 2 *Inventories*

D14 In IAS 2, paragraph 7 is amended as follows:

7 Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. ~~Fair value reflects the amount for which the same inventory could be exchanged between knowledgeable and willing buyers and sellers in the marketplace.~~ Fair value reflects the price in an orderly transaction between market participants to sell the same inventory in the most advantageous market for that inventory. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.

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IAS 16 *Property, Plant and Equipment*

D15 Paragraphs 32 and 33 are deleted.

D16 Paragraphs 72 and 77 are amended as follows:

72 The consideration receivable on disposal of an item of property, plant and equipment is recognised initially at its fair value. If payment for the item is deferred, ~~the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent~~ the difference between the nominal amount of the consideration and its fair value is recognised as interest revenue in accordance with IAS 18 reflecting the effective yield on the receivable.

77 If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed in addition to the disclosure requirements of IFRS X:

(a) the effective date of the revaluation;

(b) whether an independent valuer was involved;

(c) [deleted] ~~**the methods and significant assumptions applied in estimating the items' fair values;**~~

(d) [deleted] ~~**the extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques;**~~

(e) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and

(f) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

IAS 18 *Revenue*

D17 Paragraphs 10 and 11 are amended as follows:

10 The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable. ~~taking into account~~ ~~t~~The consideration

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received or receivable takes into account the amount of any trade discounts and volume rebates allowed by the entity.

11 In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined in accordance with [draft] IFRS X. ~~by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:~~

~~(a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or~~

~~(b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.~~

The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IAS 39.

IAS 19 *Employee Benefits*

D18 Paragraphs 102, 104, and 104D are amended as follows:

102 The fair value of any plan assets is deducted in determining the amount recognised in the statement of financial position under paragraph 54. ~~When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).~~ The fair value of any plan assets is determined in accordance with [draft] IFRS X.

104 Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, as a practical expedient, the fair value of

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those insurance policies is deemed to be the present value of the related obligations, as described in paragraph 54 (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

104D If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, as a practical expedient, the fair value of the reimbursement right is deemed to be the present value of the related obligation, as described in paragraph 54 (subject to any reduction required if the reimbursement is not recoverable in full).

D19 Paragraph 120A(ea) is added as follows (paragraph 120A(e) is not proposed for amendment but is reproduced here to provide context):

120A An entity shall disclose the following information about defined benefit plans:

...

(e) a reconciliation of the opening and closing balances of the fair value of plan assets and of the opening and closing balances of any reimbursement right recognised as an asset in accordance with paragraph 104A showing separately, if applicable, the effects during the period attributable to each of the following:

(i) expected return on plan assets,

(ii) actuarial gains and losses,

(iii) foreign currency exchange rate changes on plans measured in a currency different from the entity's presentation currency,

(iv) contributions by the employer,

(v) contributions by plan participants,

(vi) benefits paid,

(vii) business combinations and

(viii) settlements.

(ea) the disclosures required by [draft] IFRS X for each category of plan assets disclosed in compliance with the requirement in (j) except as follows. If an entity adopting the deferred

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recognition model of recognising some changes in the value of plan assets and in the defined benefit obligation in periods after the period in which they occur, the entity shall disclose gains or losses on plan assets but need not distinguish between amounts recognised in profit or loss from amounts recognised in other comprehensive income as required by paragraph 57(e)(i), (e)(ii) and (f) of [draft] IFRS X.

IAS 26 *Accounting and Reporting by Retirement Benefit Plans*

D20 Paragraphs 32 and 33 are amended as follows:

32 Retirement benefit plan investments shall be carried at fair value determined in accordance with [draft] IFRS X *Fair Value Measurement*, except as specified in paragraph 33. ~~In the case of marketable securities fair value is market value.~~ Where plan investments are held for which an estimate of fair value is not possible disclosure shall be made of the reason why fair value is not used.

33 ~~In the case of marketable securities fair value is usually market value because this is considered the most useful measure of the securities at the report date and of the investment performance for the period. Those~~ S~~s~~ecurities that have a fixed redemption value and that have been acquired to match the obligations of the plan, or specific parts thereof, may be carried at amounts based on their ultimate redemption value assuming a constant rate of return to maturity. Where plan investments are held for which a~~n~~ reliable estimate of fair value cannot be determined, ~~is not possible, such as total ownership of an entity,~~ disclosure is made of the reason why fair value is not used. To the extent that investments are carried at amounts other than market value or fair value, fair value is generally also disclosed. Assets used in the operations of the fund are accounted for in accordance with the applicable IFRSs ~~Standards~~.

IAS 33 *Earnings per Share*

D21 Paragraph 8 is amended as follows:

8 Terms defined in IAS 32 *Financial Instruments: Presentation* are used in this Standard with the meanings specified in paragraph 11 of IAS 32, unless otherwise noted. IAS 32 defines financial instrument,

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financial asset, financial liability~~,~~ and equity instrument ~~and fair value,~~ and provides guidance on applying those definitions. [Draft] IFRS X *Fair Value Measurement* defines fair value and provides guidance on applying that definition.

IAS 34 *Interim Financial Reporting*

D22 Paragraph 16(k) is added as follows:

16 An entity shall include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis. However, the entity shall also disclose any events or transactions that are material to an understanding of the current interim period:

...

(k) for financial instruments, the disclosures about fair value required by paragraphs 56–59 and 61 of [draft] IFRS X *Fair Value Measurement* and paragraphs 25, 26 and 28–30 of IFRS 7 *Financial Instruments: Disclosures*.

IAS 36 *Impairment of Assets*

D23 Paragraph 6 is amended as follows:

6 The following terms are used in this Standard with the meanings specified:

~~**An *active market* is a market where all the following conditions exist:**~~

~~**(a) the items traded within the market are homogeneous;**~~

~~**(b) willing buyers and sellers can normally be found at any time; and**~~

~~**(c) prices are available to the public.**~~

...

D24 Paragraphs 25–27 are deleted and paragraph 25A is added as follows:

25A Fair value is determined in accordance with [draft] IFRS X.

IAS 38 *Intangible Assets*

D25 The heading above paragraph 35 is amended as follows:

~~Measuring the fair value of an~~ ~~i~~Intangible asset acquired in a business combination

D26 Paragraphs 39–41 and 130E are deleted.

IAS 39 *Financial Instruments: Recognition and Measurement*

D27 Paragraph 43A is added. Paragraph 43 is not proposed for amendment but is included here for ease of reference:

43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

43A However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, the entity shall apply paragraph AG76.

D28 Paragraphs 48 and 48A are deleted.

D29 Paragraph 48B is added as follows:

48B An entity shall apply [draft] IFRS X to a holding of a financial instrument without adjusting the price per unit for the number of units held. For example, if there is a quoted price in an active market for a financial instrument, the fair value of the holding is the product of that price and the number of units held.

D30 In Appendix A, paragraphs AG46 and AG64 are amended as follows:

AG46 In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in paragraphs 48B and 49 and [draft] IFRS X ~~AG69–AG82~~ in addition to paragraph 28.

AG64 The fair value of a financial instrument on initial recognition is normally the transaction price. ~~(~~ie the fair value of the consideration given or received~~,~~ (see also paragraph 36 of [draft]

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IFRS X and paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated in accordance with [draft] IFRS X~~, using a valuation technique (see paragraphs AG74–AG79)~~. For example, the fair value of a long term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

D31 Paragraphs AG69–AG75 are deleted.

D32 Paragraph AG76 is amended as follows:

AG76 ~~Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased.~~ The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (see paragraph 36 of [draft] IFRS X ~~ie the fair value of the consideration given or received~~). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 43A, the entity shall measure ~~unless the fair value of~~ that instrument at that date as follows:

(a) at the measurement required by paragraph 43, if that fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 43, adjusted to defer the difference between the

fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

D33 Paragraphs AG76A–AG79 and AG82 are deleted.

D34 As a consequence, in the following IFRSs cross-references to paragraphs AG69–AG79 are replaced with references to [draft] IFRS X:

IFRS 1	Paragraph D20
IFRS 7	Paragraph 28

IAS 40 *Investment Property*

D35 Paragraphs 36–40, 42–49, 51 and 75(d) are deleted.

D36 Paragraph 36A is added as follows:

36A The fair value of investment property is determined in accordance with [draft] IFRS X.

D37 Paragraph 80 is amended as follows:

80 An entity that has previously applied IAS 40 (2000) and elects for the first time to classify and account for some or all eligible property interests held under operating leases as investment property shall recognise the effect of that election as an adjustment to the opening balance of retained earnings for the period in which the election is first made. In addition:

(a) if the entity has previously disclosed publicly (in financial statements or otherwise) the fair value of those property interests in earlier periods (determined on a basis that satisfies the definition of fair value in paragraph 5 ~~and the guidance in paragraphs 36–52~~), the entity is encouraged, but not required:

(i) to adjust the opening balance of retained earnings for the earliest period presented for which such fair value was disclosed publicly; and

(ii) to restate comparative information for those periods; and

(b) ...

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IAS 41 *Agriculture*

D38 Paragraph 8 is amended as follows:

8 The following terms are used in this Standard with the meanings specified:

~~**An *active market* is a market where all the following conditions exist:**~~

~~**(a) the items traded within the market are homogeneous;**~~

~~**(b) willing buyers and sellers can normally be found at any time; and**~~

~~**(c) prices are available to the public.**~~

...

D39 Paragraphs 9, 17–21 and 23 are deleted.

IFRIC 13 *Customer Loyalty Programmes*

D40 In the Application Guidance paragraph AG2 is amended as follows:

AG2 An entity may estimate the fair value of award credits by reference to the fair value of the awards for which they could be redeemed. The fair value of these awards would be reduced to take into account:

(a) the fair value of awards that would be offered to customers who have not earned award credits from an initial sale;~~ and~~

(b) the proportion of award credits that are not expected to be redeemed by customers~~.~~; and

(c) non-performance risk.

If customers can choose from a range of different awards, the fair value of the award credits will reflect the fair values of the range of available awards, weighted in proportion to the frequency with which each award is expected to be selected.

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Approval of *Fair Value Measurement* by the Board

The exposure draft *Fair Value Measurement* was approved for publication by the fourteen members of the International Accounting Standards Board.

Sir David Tweedie	Chairman
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Stephen Cooper	
Philippe Danjou	
Jan Engström	
Robert P Garnett	
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Prabhakar Kalavacherla	
James J Leisenring	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

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May 2009

Basis for Conclusions
Exposure Draft ED/2009/5

Fair Value Measurement

Comments to be received by 28 September 2009

International
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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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IASC Foundation Publications Department,
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Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
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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.

[*] 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

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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:

(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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May 2009

Illustrative Examples
Exposure Draft ED/2009/5

Fair Value Measurement

Comments to be received by 28 September 2009

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Draft Illustrative Examples

Exposure Draft

FAIR VALUE MEASUREMENT

Comments to be received by 28 September 2009

ED/2009/5

These draft Illustrative Examples accompany 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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IFRS X *Fair Value Measurement* [Draft] Illustrative examples

These [draft] examples accompany, but are not part of, [draft] IFRS X

Highest and best use and valuation premise

IE1 Examples 1–3 illustrate the application of the 'highest and best use' and valuation premise concepts when non-financial assets are newly acquired.

Example 1—Asset group

IE2 An entity, a strategic buyer, acquires a group of assets (Assets A, B and C) in a business combination. Asset C is billing software developed by the acquired entity for its own use in conjunction with Assets A and B (related assets). The entity measures the fair value of each of the assets individually, consistently with the specified unit of account for the assets. The entity determines that there is no alternative use for the assets (the highest and best use of the assets is their current use) and that each asset would provide maximum value to market participants principally through its use in combination with other assets as a group (ie the valuation premise is 'in use').

IE3 In this instance, the reporting entity would sell the assets in the market in which it initially acquired the assets (ie the 'entry' and 'exit' markets from the perspective of the reporting entity are the same). Market participant buyers with whom the reporting entity would trade in that market have characteristics that are generally representative of both financial buyers and strategic buyers and include those buyers that initially bid for the assets.[*] As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:

(a) Strategic buyer asset group. The entity determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (market participant synergies). Those assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period

[*] Although market participant buyers might be broadly classified as strategic or financial buyers, there will often be differences among the market participant buyers within each of those groups, reflecting, for example, different uses for an asset and different operating strategies.

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and could not be sold on its own at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are CU360,* CU260 and CU30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is CU650.

(b) Financial buyer asset group. The entity determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (the billing software) would be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the financial buyer asset group are CU300, CU200 and CU100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is CU600.

IE4 The fair values of Assets A, B and C would be determined on the basis of the use of the assets as a group within the strategic buyer group (CU360, CU260 and CU30). Although the use of the assets within the strategic buyer group does not maximise the fair value of each of the assets individually, it maximises the fair value of the assets as a group (CU650).

Example 2—Land

IE5 An entity acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. As an industrial property (the current use), the indicated value of the land and factory is CU100,000 and CU60,000, respectively. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, the entity determines that the land currently used as a site for a factory could be developed as a site for residential use (for high-rise apartment buildings).

IE6 The highest and best use of the land would be determined by comparing (a) the value of the land as currently developed for industrial use ('in use') and (b) the value of the land as a vacant site for residential use, considering the costs of demolishing the factory and other costs necessary to convert the land to a vacant site ('in exchange'). In this situation, the highest and best use of the land would be to develop

* In these [draft] examples, monetary amounts are denominated in 'currency units (CU)'.

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high-rise apartment buildings ('in exchange'). As a residential property, the indicated fair value of the vacant site is CU300,000 after considering the costs to demolish the factory and other costs of conversion to a vacant site.

IE7 Because the current use of the land differs from its highest and best use, the fair value of the asset group (land and factory) has two components: (a) the value of the assets assuming their current use as industrial property and (b) the amount by which the fair value of the assets differs from their value in their current use. The amount in (b) is determined by subtracting the current-use value of the land and factory (CU160,000) from the fair value of the vacant site (CU300,000).

IE8 The entity measures the land at CU240,000. This is the current-use value of the land (CU100,000) plus the incremental value of the land (CU140,000) that relates to the ability to convert the land from its current use to its highest and best use. The entity measures the factory at CU60,000. The entity accounts for the assets in accordance with the IFRSs applicable to those assets.

Example 3—Research and development project

IE9 An entity acquires a research and development (R&D) project in a business combination. The entity does not intend to complete the project. If completed, the project would compete with one of its own R&D projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (lock up) the R&D project to prevent its competitors from obtaining access to the technology. The project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology. To measure the fair value of the R&D project at initial recognition, the highest and best use of the project would be determined on the basis of its use by market participants. For example:

(a) the highest and best use of the R&D project would be to continue development (thus the in-use valuation premise would be appropriate) if market participants would continue to develop it and that use would maximise the value of the group of assets in which the project would be used. That might be the case if market participants do not have similar technology (in development or commercialised). The fair value of the R&D project, measured using an in-use valuation premise, would be determined on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used with its

complementary assets as a group and that those assets would be available to market participants.

(b) the highest and best use of the R&D project would be to cease development (thus the in-use valuation premise would be appropriate) if, for competitive reasons, market participants would lock up the project and that use would maximise the value of the group of assets in which the project would be used (as a locked-up project). That might be the case if market participants have technology in a more advanced stage of development that would compete with the R&D project (if completed) and the project would be expected to provide defensive value (if locked up). The fair value of the R&D project, measured using an in-use valuation premise, would be determined on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used (locked up) with its complementary assets as a group and that those assets would be available to market participants.

(c) the highest and best use of the R&D project would be to cease development (thus the in-exchange valuation premise would be appropriate) if market participants would discontinue its development. That might be the case if the project is not expected to provide a market rate of return (if completed) and would not otherwise provide defensive value (if locked up). The fair value of the R&D project, measured using an in-exchange valuation premise, would be determined on the basis of the price that would be received to sell the R&D project by itself (which might be nil).

Valuation techniques

IE10 The [draft] IFRS notes that a single valuation technique will be appropriate in some cases. In other cases, multiple valuation techniques will be appropriate. Examples 4 and 5 illustrate the use of multiple valuation techniques.

Example 4—Machine held and used

IE11 An entity acquired a machine in a business combination that is held and used in its operations. The machine, initially purchased from an outside vendor, was subsequently customised by the entity for use in its operations. However, the customisation of the machine was not extensive. The entity determines that the asset would provide maximum

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value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use). Therefore, the highest and best use of the machine is its current use and the valuation premise is 'in use'.

IE12 The entity determines that sufficient data are available to apply the cost approach and, because the customisation of the machine was not extensive, the market approach. The income approach is not used because the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows. Furthermore, information about short-term and intermediate-term lease rates for similar used machinery that otherwise could be used to project an income stream (lease payments over remaining service lives) is not available. The market and cost approaches are applied as follows:

(a) The market approach is applied using quoted prices for similar machines adjusted for differences between the machine (as customised) and the similar machines. The measurement reflects the price that would be received for the machine in its current condition (used) and location (installed and configured for use). The fair value indicated by that approach ranges from CU40,000 to CU48,000.

(b) The cost approach is applied by estimating the amount that would currently be required to construct a substitute (customised) machine of comparable utility. The estimate considers the condition of the machine and the environment in which it operates, including physical wear and tear (physical deterioration), improvements in technology (functional obsolescence), conditions external to the condition of the machine such as a decline in the market demand for similar machines (economic obsolescence) and installation costs. The fair value indicated by that approach ranges from CU40,000 to CU52,000.

IE13 The entity determines that the fair value indicated by the market approach is more representative of fair value than the fair value indicated by the cost approach and, therefore, ascribes more weight to the results of the market approach. That determination is made on the basis of the relative subjectivity of the inputs, considering the degree of comparability between the machine and the similar machines. In particular:

(a) the inputs used in the market approach (quoted prices for similar machines) require fewer and less subjective adjustments than the inputs used in the cost approach.

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(b) the range indicated by the market approach overlaps with, but is narrower than, the range indicated by the cost approach.

(c) there are no known unexplained differences (between the machine and the similar machines) within that range.

The entity further determines that the higher end of the range indicated by the market approach is most representative of fair value, largely because the majority of relevant data points in the market approach lie at or near the higher end of the range. Accordingly, the entity determines that the fair value of the machine is CU48,000.

IE14 If customisation of the machine was extensive or if there were not sufficient data available to apply the market approach (eg because market data reflect an in-exchange valuation premise [scrap value for specialised assets] rather than an in-use valuation premise), the entity would apply the cost approach. When using an in-use valuation premise, the cost approach assumes the sale of the machine to a market participant buyer with complementary assets. The price received for the sale of the machine (exit price) would not be more than the cost that a market participant buyer would incur to acquire or construct a substitute machine of comparable utility. Nor would that price be more than the economic benefit that a market participant buyer would derive from the use of the machine.

Example 5—Software asset

IE15 An entity acquires a group of assets. The asset group includes an income-producing software asset internally developed for licence to customers and its complementary assets (including a related database with which the software asset is used). To allocate the cost of the group to the individual assets acquired, the entity measures the fair value of the software asset. The entity determines that the software asset would provide maximum value to market participants through its use in combination with other assets (its complementary assets) as a group. Therefore, the highest and best use of the software asset is its current use and the valuation premise is 'in use'. (In this case, the licensing of the software asset, in and of itself, does not make the valuation premise of the software asset 'in exchange'.)

IE16 The entity determines that, in addition to the income approach, sufficient data might be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available. The income and cost approaches are applied as follows:

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(a) The income approach is applied using a present value technique. The cash flows used in that technique reflect the income stream expected to result from the software asset (licence fees from customers) over its economic life. The fair value indicated by that approach is CU15 million.

(b) The cost approach is applied by estimating the amount that would be required currently to construct a substitute software asset of comparable utility (considering functional and economic obsolescence). The fair value indicated by that approach is CU10 million.

IE17 Through its application of the cost approach, the entity determines that market participants would not be able to construct a substitute software asset of comparable utility. Some characteristics of the software asset are unique, having been developed using proprietary information, and cannot be readily replicated. The entity determines that the fair value of the software asset is CU15 million, as indicated by the income approach.

Fair value hierarchy

IE18 Example 6 illustrates the use of Level 1 inputs to measure the fair value of an asset that trades in different active markets with different prices.

Example 6—Level 1 most advantageous market

IE19 An asset is sold in two different active markets with different prices. An entity enters into transactions in both markets. In Market A, the price that would be received is CU27, transaction costs in that market are CU2 and the costs to transport the asset to that market are CU3 (the net amount that would be received is CU22). In Market B, the price that would be received is CU26, transaction costs in that market are CU2 and the costs to transport the asset to that market are CU1 (the net amount that would be received in Market B is CU23).

IE20 The fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after considering transaction costs and transport costs.

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IE21 Because the entity would maximise the net amount that would be received for the asset in Market B (CU23), the fair value of the asset would be measured using the price in that market (CU26), less transport costs (CU1), resulting in a measurement of CU25. Although transaction costs are considered when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

Transaction prices and fair value at initial recognition

IE22 Example 7 illustrates when the price in a transaction involving a derivative instrument might (and might not) equal the fair value of the instrument at initial recognition.

Example 7—Interest rate swap at initial recognition

IE23 Entity A (a retail counterparty) enters into an interest rate swap in a retail market with Entity B (a securities dealer) for no initial consideration (transaction price is zero). Entity A can access only the retail market. Entity B can access both the retail market (with retail counterparties) and the inter-dealer market (with securities dealer counterparties).

(a) From the perspective of Entity A, the retail market in which it initially entered into the swap is the most advantageous market for the swap; if Entity A were to transfer its rights and obligations under the swap, it would do so with a securities dealer counterparty in that market. In that case, the transaction price (zero) would represent the fair value of the swap to Entity A at initial recognition, ie the price that Entity A would receive (or pay) to sell (or transfer) the swap in a transaction with a securities dealer counterparty in the retail market (an exit price). That price would not be adjusted for any incremental (transaction) costs that would be charged by that securities dealer counterparty.

(b) From the perspective of Entity B, the inter-dealer market (not the retail market) is the most advantageous market for the swap; if Entity B were to transfer its rights and obligations under the swap, it would do so with a securities dealer in that market. Because the market in which Entity B initially entered into the swap is different from the most advantageous market for the swap, the transaction price (zero) would not necessarily represent the fair value of the swap to Entity B at initial recognition. If the fair value differs from

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the transaction price (zero), Entity B applies IAS 39 *Financial Instruments: Recognition and Measurement* to determine whether it recognises that difference as a gain or loss.

Restricted assets

IE24 Examples 8 and 9 illustrate the effect of restrictions when measuring the fair value of an asset.

Example 8—Restriction on the sale of an equity instrument

IE25 An entity holds an equity instrument (a financial asset) for which sale is legally restricted for a specified period. (For example, such a restriction could limit sale to qualifying investors.) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants. In that case, the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment will vary depending on the nature and duration of the restriction, the extent to which buyers are limited by the restriction (eg there might be a large number of qualifying investors) and factors specific to both the instrument and the issuer (qualitative and quantitative).

Example 9—Restrictions on the use of an asset

IE26 A donor contributes land in an otherwise developed residential area to a not-for-profit neighbourhood association. The land is currently used as a playground. The donor specifies that the land must continue to be used by the association as a playground in perpetuity. Upon review of relevant documentation (legal and other), the association determines that the fiduciary responsibility to meet the donor's restriction would not be transferred to market participants if the association sold the asset, ie the donor restriction on the use of the land is specific to the association. Furthermore, the association is not restricted from selling the land.

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Without the restriction on the use of the land by the association, the land could be used as a site for residential development. In addition, the land is subject to an easement (a legal right that enables a utility to run power lines across the land).

(a) *Donor restriction on use of land*. Because in this instance the donor restriction on the use of the land is specific to the association, the restriction would not be transferred to market participants. Therefore, the fair value of the land would be based on the higher of its fair value 'in use' as a playground or fair value 'in exchange' as a site for residential development, regardless of the restriction on the use of the land by the association.

(b) *Easement for utility lines*. Because the easement for utility lines is specific to (a characteristic of) the land, it would be transferred to market participants with the land. Therefore, the fair value measurement of the land would consider the effect of the easement, regardless of whether the valuation premise is 'in use' as a playground or 'in exchange' as a site for residential development.

Liabilities and credit risk

IE27 Non-performance risk relating to a liability includes an entity's credit risk. An entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value because those who hold the entity's obligations as assets would consider the effect of the entity's credit standing in determining the prices they would be willing to pay. For example, assume that Entity X and Entity Y each enter into a contractual obligation to pay cash (CU500) to Entity Z in five years. Entity X has an AA credit rating and can borrow at 6 per cent, while Entity Y has a BBB credit rating and can borrow at 12 per cent. Entity X will receive about CU374 in exchange for its promise (the present value of CU500 in five years at 6 per cent). Entity Y will receive about CU284 in exchange for its promise (the present value of CU500 in five years at 12 per cent). At initial recognition, the fair value of the liability to each entity (the proceeds) incorporates that entity's credit standing. Example 10 illustrates the effect of credit standing on the fair value of a financial liability at initial recognition and in subsequent periods.

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Example 10—Structured note

IE28 On 1 January 20X7 Entity A, an investment bank with an AA credit rating, issues a five-year fixed rate note to Entity B. No credit enhancements are issued in conjunction with or otherwise related to the contract (ie no collateral is posted and there is no third-party guarantee). Entity A elects to account for the entire note at fair value in accordance with IAS 39. The fair value of the note (the obligation of Entity A) during 20X7 is measured using an expected present value technique. Changes in fair value are discussed below.

(a) *Fair value at 1 January 20X7*. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the government bond curve at 1 January 20X7), plus the current market observable AA corporate bond spread to government bonds adjusted (up or down) for Entity A's specific credit risk (credit-adjusted risk-free rate). Therefore, the fair value of Entity A's obligation at initial recognition considers non-performance risk, including that entity's credit risk (presumably, reflected in the proceeds).

(b) *Fair value at 31 March 20X7* During March 20X7, the credit spread for AA corporate bonds widens, with no changes to the specific credit risk of Entity A. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the government bond curve at 31 March 20X7), plus the current market observable AA corporate bond spread to government bonds, adjusted for Entity A's specific credit risk (credit-adjusted risk-free rate). Entity A's specific credit risk is unchanged from initial recognition. Therefore, the fair value of Entity A's obligation changes as a result of changes in credit spreads generally. Changes in credit spreads reflect current market participant assumptions about changes in non-performance risk generally.

(c) *Fair value at 30 June 20X7*. As of 30 June 20X7, there have been no changes to the AA corporate bond spreads. However, on the basis of structured note issues corroborated with other qualitative information, Entity A determines that its own specific creditworthiness has strengthened within the AA credit spread. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the government bond yield curve at 30 June 20X7), plus the current market observable AA corporate bond spread to government bonds (unchanged from 31 March 20X7), adjusted for Entity A's specific

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credit risk (credit-adjusted risk-free rate). Therefore, the fair value of the obligation of Entity A changes as a result of the change in its own specific credit risk within the AA corporate bond spread.

Fair value measurements in markets that are not active

IE29 Example 11 illustrates the use of judgement when measuring the fair value of a financial asset when the market for that financial asset is not active.

Example 11—Inactive market

IE30 Entity A invested in a junior AAA-rated tranche of a residential mortgage-backed security (RMBS) on 1 January 20X8 (the issue date of the security). The junior tranche is the third most senior of a total of seven tranches. The underlying collateral for the RMBS is unguaranteed residential mortgage loans that were issued in the second half of 20X6.

IE31 At 31 March 20X9 (the measurement date), the junior tranche is now A-rated. This tranche of the RMBS was previously traded through a brokered market. However, trading volume in that market was infrequent, with only a few transactions taking place per month from 1 January 20X8 to 30 June 20X8 and little, if any, trading activity during the nine months before 31 March 20X9.

IE32 Entity A considers the factors in paragraph B5 of the [draft] IFRS to determine whether the market for the junior tranche of the RMBS is not active. After evaluating the significance and relevance of the factors, Entity A concludes that the market is not active. Entity A supported its judgement primarily on the basis that there was little, if any, trading activity for an extended period of time before the measurement date.

IE33 Because there is little, if any, trading activity to support a valuation technique using a market approach, Entity A decides to use an income approach to estimate the fair value of its security at the measurement date. Entity A estimates a discount rate (ie market rate of return) to discount the contractual cash flows from the RMBS. The market rate of return is estimated using the risk-free rate of interest and a margin that reflects the risks (eg default risk, collateral value risk and liquidity risk) that market participants would consider when pricing the asset in an orderly transaction at the measurement date.

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IE34 Entity A considered the following information when estimating the margin:

(a) the credit spread for the junior tranche of the RMBS at the issue date as implied by the original transaction price

(b) the change in the credit spread implied by any observed transactions from the issue date to the measurement date for comparable RMBSs or on the basis of relevant indices

(c) the characteristics of the junior tranche of the RMBS compared with comparable RMBSs or indices, including the quality of the underlying assets (ie information about the performance of the underlying mortgage loans such as delinquency and foreclosure rates, loss experience and prepayment rates), seniority or subordination of the RMBS tranche held and other relevant factors

(d) relevant reports issued by analysts and rating agencies

(e) quoted prices from third parties such as brokers or pricing services.

IE35 Entity A estimates that one indication of the market rate of return that market participants would use when pricing the junior tranche is 12 per cent (1,200 basis points). This market rate of return was estimated as follows:

(a) 300 basis points for the relevant risk-free rate of interest at 31 March 20X9.

(b) Add: 250 basis points for the credit spread over the risk-free rate when the junior tranche was issued in January 20X8.

(c) Add: 700 basis points for the estimated change in the credit spread over the risk-free rate of the junior tranche between 1 January 20X8 and 31 March 20X9. This estimate was based on the change in the most comparable index available for that time period.

(d) Subtract: 50 basis points (net) to adjust for differences between the index used to estimate the change in credit spreads and the junior tranche. The reference index consists of subprime mortgage loans, while Entity A's RMBS consists of mortgage loans with a more favourable credit profile (making it more attractive to market participants). However, the index does not reflect an appropriate liquidity risk premium for the junior tranche under current market conditions. Thus, the 50 basis point adjustment is the net of two adjustments:

(i) the first adjustment is a 350 basis point subtraction, which was estimated by comparing the implied yield from the most

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recent transactions for the RMBS in June 20X8 with the implied yield in the index price on those same dates. There was no information available that indicated that the relationship between Entity A's security and the index has changed.

(ii) the second adjustment is a 300 basis point addition, which is Entity A's best estimate of the additional liquidity risk inherent in its security (a cash position) when compared with the index (a synthetic position). This estimate was derived after considering liquidity risk premiums implied in recent cash transactions for a range of similar securities.

IE36 As an additional indication of the market rate of return, Entity A considers two recent indicative quotes (ie non-binding quotes) provided by reputable brokers for the junior tranche that imply yields of 15–17 per cent. Entity A is unable to evaluate the valuation techniques or inputs used to develop the quotes. However, Entity A is able to confirm that the quotes are not based on transactions.

IE37 Because Entity A has multiple indications of the market rate of return that market participants would consider when measuring fair value, it evaluates and weights the respective indications of the rate of return, considering the reasonableness of the range indicated by the results.

IE38 Entity A concludes that 13 per cent is the point within the range of indications that is most representative of fair value under current market conditions. Entity A placed more weight on the 12 per cent indication (ie its own estimate of the market rate of return) for the following reasons:

(a) Entity A concluded that its own estimate appropriately incorporated the risks (eg default risk, collateral value risk and liquidity risk) that market participants would use when pricing the asset in an orderly transaction under current market conditions

(b) the broker quotes were non-binding and were not based on transactions and Entity A was unable to evaluate the valuation techniques or inputs used to develop the quotes.

Fair value disclosure

IE39 The disclosures required by paragraph 57(a) and (b) and paragraph 57(e) and (f) of the [draft] IFRS are illustrated below.

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Example 12—Assets measured at fair value

IE40 For assets and liabilities measured at fair value during the period, the [draft] IFRS requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. An entity might disclose the following for assets to comply with paragraph 57(a) and (b) of the [draft] IFRS:

Assets measured at fair value

		Fair value measurement at the end of the reporting period using:		
		Quoted prices in active markets for identical assets	Significant other observable inputs	Significant unobservable inputs
		(Level 1)	(Level 2)	(Level 3)
Description	31 Dec 20X2	CU million	CU million	CU million
Financial assets at fair value through profit or loss				
Trading securities	100	40	55	5
Trading derivatives	39	17	20	2
Available-for-sale financial assets				
Equity investments	75	30	40	5
Investment properties				
Land	40	-	25	15
Buildings	15	-	-	15
Total	269	87	140	42

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

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Example 13—Fair value measurements in Level 3 of the fair value hierarchy

IE41 For assets and liabilities measured at fair value in Level 3 of the fair value hierarchy, the [draft] IFRS requires a reconciliation from the opening balances to the closing balances for each class of assets and liabilities. An entity might disclose the following for assets to comply with paragraph 57(e) and (f) of the [draft] IFRS:

Assets measured at fair value in Level 3 of the fair value hierarchy

	Fair value measurement at the end of the reporting period					
	Financial assets at fair value through profit or loss		**Available-for- sale financial assets**		**Investment properties**	**Total**
	Trading securities	Trading derivatives	Equity investments	Land	Buildings	
	CU million	CU million	CU million	CU million	CU million	CU million
Opening balance	6	5	4	10	12	37
Total gains or losses						
in profit or loss	(2)	(2)[(a)]	-	5	3	4
in other comprehensive income	-	-	(1)	-	-	(1)
Purchases	1	2	2	-	-	5
Issues	-	-	-	-	-	-
Settlements	-	(1)	-	-	-	(1)
Transfers into or out of Level 3	-	(2)	-	-	-	(2)
Closing balance	5	2	5	15	15	42
Gains or losses in profit or loss for assets held at the end of the reporting period	(1)	(1)	-	5	3	6

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

(a) Losses of CU0.05 that have been reported in Level 3 are offset by gains or losses on instruments categorised within Level 1 or Level 2 of the fair value hierarchy.

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Gains and losses in profit or loss for the period (above) are reported in trading income and in other income as follows:

	Trading income	Other income
	CU million	CU million
Total gains or losses included in profit or loss for the period	(4)	8
Gains or losses in profit or loss for assets held at the end of the reporting period	(2)	8

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

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Appendix
[Draft] Amendments to guidance on other IFRSs

The following [draft] amendments to guidance on other IFRSs are necessary in order to ensure consistency with [draft] IFRS X Fair Value Measurement *and the related amendments to other IFRSs. Amended paragraphs are shown with new text underlined and deleted text struck through.*

IFRS 7 *Financial Instruments: Disclosures*

IGA1 The reference to paragraph AG76A of IAS 39 in paragraph IG14 in the Guidance on Implementing IFRS 7 is amended to refer to paragraph AG76(b).

IAS 39 *Financial Instruments: Recognition and Measurement*

IGA2 The Guidance on Implementing IAS 39 is amended as follows:

Question and answer E.2.1 is deleted.

Question and answer E.2.2 is amended as follows:

E.2.2 Fair value measurement: large holding

Entity A holds 15 per cent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is CU100. Daily trading volume is 0.1 per cent of outstanding shares. Because Entity A believes that it could sell its share in ~~the fair value of the~~ Entity B ~~shares it owns, if sold~~ as a block~~, is greater~~ for more than the quoted market price, Entity A obtains ~~several~~ independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A ~~w~~could ~~be able to~~ obtain a price of CU105, ie a 5 per cent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

~~Under~~ In accordance with IAS 39.48A ~~AG71~~, ~~a published price quotation in an active market is the best estimate of fair value~~ if there is a quoted price in an active market for a financial instrument the fair value of the holding is the product of that price and the number of units held. Therefore, Entity A uses the published price quotation (CU100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

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IFRIC 13 *Customer Loyalty Programmes*

IGA3 In the illustrative examples accompanying IFRIC 13, paragraphs IE1–IE5 are amended as follows:

IE1 A grocery retailer operates a customer loyalty programme. It grants programme members loyalty points when they spend a specified amount on groceries. Programme members can redeem the points for further groceries. The points have no expiry date. In one period, the entity grants 100 points. Management estimates that a market participant would expect~~s~~ 80 of these points to be redeemed. ~~Management estimates~~ ~~t~~The fair value of each loyalty point ~~to be~~ is one currency unit (CU1).~~, and~~ Accordingly, management defers revenue of CU100. Throughout the example, management determines that non-performance risk has an immaterial effect on the measurement of its obligation under the programme.

Year 1

IE2 At the end of the first year, 40 of the points have been redeemed in exchange for groceries, ie half of those expected to be redeemed. The entity recognises revenue of (40 points/80[*] points) × CU100 = CU50.

Year 2

IE3 In the second year, management revises its estimate of market participant expectations. It now expects 90 points to be redeemed altogether.

IE4 During the second year, 41 points are redeemed, bringing the total number redeemed to 40[†] + 41 = 81 points. The cumulative revenue that the entity recognises is (81 points/90[§] points) × CU100 = CU90. The entity has recognised revenue of CU50 in the first year, so it recognises CU40 in the second year.

* total number of points expected to be redeemed

† number of points redeemed in year 1

§ revised estimate of total number of points expected to be redeemed

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Year 3

IE5 In the third year, a further nine points are redeemed, taking the total number of points redeemed to 81 + 9 = 90. Management continues to estimate that market participants expect ~~that~~ only 90 points will ever be redeemed, ie that no more points will be redeemed after the third year. So the cumulative revenue to date is (90 points/90[*] points) × CU100 = CU100. The entity has already recognised CU90 of revenue (CU50 in the first year and CU40 in the second year). So it recognises the remaining CU10 in the third year. All of the revenue initially deferred has now been recognised.

[*] total number of points still expected to be redeemed

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