A COMPARATIVE APPROACH OF FAIR VALUE CONCEPT

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Abstract: *The objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price). Statement of Financial Accounting Standards 157 clarifies fair value in terms of the price in an orderly transaction between market participants to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability. 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. IFRSs require some assets, liabilities and equity instruments to be measured at fair value in some circumstances. However, guidance on measuring fair value is dispersed throughout IFRSs and is not always consistent.*

According with Statement of Financial Accounting Standards157 (SFAS 157) 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.

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 prior to 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 (for example, a forced liquidation or distress sale). 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. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

The majority of IASB members believe that a fair value measurement with an exit price objective is consistent with these definitions and is appropriate because it reflects current market-based expectations of flows of economic benefit into or out of the entity.

On the another hand, an entry price also reflects current market-based expectations of flows of economic benefit into or out of the entity. Therefore, they suggest replacing the term 'fair value' with terms that are more descriptive of the measurement attribute, such as 'current entry price' or 'current exit price'.

In SFAS 157, a fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability.6 Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

The IASB observed that IFRSs do not contain consistent guidance about which market should be used as a basis for measuring fair value when more than one market exists. For example, IAS 39 states that 'the objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at

which a transaction would occur at the balance sheet date in that instrument (ie without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access.'

The IASB's preliminary view agrees with the guidance in SFAS 157. The IASB reached this preliminary view because it observed that in most instances the principal market for an asset or liability will be the most advantageous market and that entities need not continuously monitor multiple markets in order to determine which market is most advantageous at the measurement date. Furthermore, the IASB reasoned that the market on which an asset or liability is principally traded provides a more liquid, and therefore more representative, input for a fair value measurement.

Some fair value measurements required by IFRSs might not be consistent with an exit price measurement objective. In particular, the IASB observes that this might be the case when fair value is required on initial recognition, such as in:

(a) IFRS 3,

(b) IAS 17 for the initial recognition of assets and liabilities by a lessee under a finance lease, and

(c) IAS 39 *Financial Instruments: Recognition and Measurement* for the initial recognition of some financial assets and financial liabilities.

In developing an exposure draft, the IASB may propose a revised definition of fair value. If so, it will complete a standard-by-standard review of fair value measurements required in IFRSs to assess whether each standard's intended measurement objective is consistent with the proposed definition. If the IASB concludes that the intended measurement objective in a particular standard is inconsistent with the proposed definition of fair value, either that standard will be excluded from the scope of the exposure draft or the intended measurement objective will be restated using a term other than fair value (such as 'current entry value').

IFRSs require some assets, liabilities and equity instruments to be measured at fair value in some circumstances. However, guidance on measuring fair value is dispersed throughout IFRSs and is not always consistent. The IASB believes that establishing a single source of guidance for all fair value measurements required by IFRSs will both simplify IFRSs and improve the quality of fair value information included in financial reports. A concise definition of fair value combined with consistent guidance that applies to all fair value measurements would more clearly communicate the objective of fair value measurement and eliminate the need for constituents to consider guidance dispersed throughout IFRSs.

The IASB emphasizes that the Fair Value Measurements project is not a means of expanding the use of fair value in financial reporting. Rather, the objective of the project is to codify, clarify and simplify existing guidance that is dispersed widely in IFRSs. However, in order to establish a single standard that provides uniform guidance for all fair value measurements required by IFRSs, amendments will need to be made to the existing guidance. As discussed further in Issue 2, the amendments might change how fair value is measured in some standards and how the requirements are interpreted and applied.

In some IFRSs the IASB (or its predecessor body) consciously included measurement guidance that results in a measurement that is treated as if it were fair value even though the guidance is not consistent with the fair value measurement objective. For example, IFRS 3 *Business Combinations* provides guidance that is inconsistent with the fair value measurement objective for items acquired in a business combination such as tax assets, tax liabilities and net employee benefit assets or liabilities for defined benefit plans. Furthermore, some IFRSs contain measurement reliability criteria. For example, IAS 16 *Property, Plant and Equipment* permit the revaluation model to be used only if fair value can be measured reliably. However, the IASB plans to use the Fair Value Measurements project to establish guidance where there currently is none, such as in IAS 17 *Leases*, as well as to eliminate inconsistent guidance that does not clearly articulate a single measurement objective. Because SFAS 157 establishes a single source of guidance and a single objective that can be applied to all fair value measurements, the IASB has reached the preliminary view that SFAS 157 is an improvement on the disparate guidance in IFRSs.

SFAS 157 states that entry prices and exit prices are conceptually different. Therefore, SFAS 157 requires entities to consider factors specific to the transaction and the asset or liability in determining whether the transaction price paid to acquire an asset or received to assume a liability represents fair value at initial recognition

When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (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). Conceptually, entry prices and exit prices are different. 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 many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

a. The transaction is between related parties.

b. The transaction occurs 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 that should be separately measured, or the transaction price includes transaction costs.

d. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

The IASB noted that the guidance on fair value at initial recognition in paragraphs 16 and 17 of SFAS 157 diverges from the guidance in paragraph AG76 of IAS 39, which states that "the best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument 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".

At present, under IAS 39, an entity may recognize the difference between a model-based estimate of fair value and the transaction price at initial recognition (day-one gain or loss) only if the model-based estimate of fair value is based entirely on observable market inputs. If this condition is not met, gains or losses on the financial asset or financial liability in periods after initial recognition can comprise changes in the model-based value *as well as* the portion of the unrecognized day-one gain or loss subsequently recognized because of a change in factors (including time).

In comparison, if the provisions of SFAS 157 were applied to IFRSs without modification, the difference between the model-based estimate of fair value and the transaction price would be recognised in profit or loss at initial recognition. Subsequent gains and losses relating to the financial asset or financial liability would then reflect *only* changes in the model-based estimate of fair value.

References:

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