

# IFRS Briefing Sheet

## Discussion Paper *Fair Value Measurements*

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This IFRS Briefing Sheet summarises the International Accounting Standards Board's (IASB) Discussion Paper *Fair Value Measurements*, which was published on 30 November 2006.

The IASB plans to review all IFRSs requiring fair value measurement, and either align them with the proposed new definition, specifically exclude them from the scope of a future exposure draft, or otherwise amend existing guidance. The IASB expects to publish an exposure draft by early 2008.

### **Summary of SFAS 157 *Fair Value Measurements***

SFAS 157 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."

The fair value of an asset is based on the exit price (i.e., selling price) rather than the entry price (i.e., purchase price). The exit price is determined using data that market participants in the entity's principal or most advantageous market would use when determining the price of that asset or liability.

The standard requires that fair value be determined on an individual unit basis (unit of account), but states that the unit of account should be determined using the applicable standard for that asset or liability.

The application of the exit price as a basis for determining fair value may lead to a so-called "Day one" gain or loss when the transaction price differs from the exit price. For example, a bank

### **Background**

This discussion paper is part of the convergence program between the IASB and the U.S. Financial Accounting Standards Board (FASB), as outlined in the joint Memorandum of Understanding published on 27 February 2006 (see *IFRS in Brief* Issue 22).

The objective of this project is to develop a consistent definition of, and to provide additional measurement guidance on, fair value; the objective is not to expand the use of fair value. This discussion paper sets out the IASB's preliminary views on the U.S. standard SFAS 157 *Fair Value Measurements*.

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might issue a structured product in a retail market at a price that is higher than the amount that it would need to pay to transfer the liability to another bank in a business-to-business market.

Any gain or loss arising from a difference between the entry and the exit price at initial recognition is recognised in profit or loss under SFAS 157, even when the fair value of the asset or liability is determined to a large extent using unobservable market data.

The standard includes a three-level hierarchy for determining fair value, which is summarised in Figure 1.

### Key Issues

The objective of the discussion paper is to receive comments on the key issues in SFAS 157 as identified by the IASB, including the following:

#### Fair Value Hierarchy

IFRSs currently do not contain a single fair value hierarchy that applies across all standards. This has led to divergence in the methods applied in different IFRSs such as IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 40 *Investment Property* and IAS 41 *Agriculture*. The IASB believes that a single fair value hierarchy could lead to more consistency in application. The preliminary view of the IASB is that the fair value hierarchy in SFAS 157 should be implemented in IFRSs (see Figure 1).

#### Definition of Fair Value

Fair value is defined in the glossary to IFRSs as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”

#### Exit or Entry Price?

SFAS 157 explicitly requires that the fair value of an asset or liability be determined based on the exit price when transferring the asset or

liability (i.e., selling price). A similar requirement does not exist under IFRSs and would conflict with certain current requirements. For example, IAS 39 states that transaction price is the best evidence of the fair value of an asset or liability upon initial recognition unless the transaction is between related parties.

The majority of IASB members support a definition of fair value that is based on exit prices as they believe that it is consistent with the definitions of an asset and a liability.

#### Liability – Transfer or Settlement?

IFRSs explicitly state that a liability should be measured at the amount at which the liability can be “settled”. The fair value of a liability under SFAS 157 is based on the notion of “transfer”. The IASB believes that “transfer” is a more accurate term when describing the objective of fair value measurement in IFRSs. Current IFRSs are based on market objectives that do not include entity-specific information, which is consistent with the notion of “transfer”.

The IASB’s preliminary view is to implement the “transfer” notion in the IFRS definition of fair value.

#### Valuation of Assets and Liabilities

SFAS 157 requires that fair value measurement include the specific attributes that market participants would take into account when pricing the asset or liability. The IASB’s preliminary view is that these factors should be considered.

SFAS 157 states that the fair value of a liability should include the risks for non-performance, including the entity’s own credit risk. IAS 39 requires that the fair value of a liability reflect the credit quality of that liability. The IASB believes that these two concepts are consistent and has the preliminary view that the fair value of a

liability should include the risk of non-performance.

SFAS 157 states that the fair value of an asset should reflect the highest and best use of that asset either with an in-use or an in-exchange assumption. The IASB is concerned that the differences between the in-use assumption as defined under SFAS 157 and the “value in use” concept in IAS 36 *Impairment of Assets* are not clear. The IASB has requested constituents’ views on this issue.

SFAS 157 states that the fair value of a financial instrument should be based on the price within the bid-ask spread that is most representative of the fair value in the specific situation. The IASB’s preliminary decision is to adopt this approach in IFRSs.

SFAS 157 states that an entity can apply mid-market prices or another pricing convention, as a practical measure for fair value measurement within the bid-ask spread. The IASB has not yet reached a preliminary view on whether IFRSs should contain a similar requirement, or on whether the bid-ask guidance should apply only when prices are observable in the market or should be applied on all levels of the hierarchy (as required by SFAS 157).

#### Recognition of “Day one” Gains and Losses

The application of the exit price as a basis for determining fair value is conceptually different from using the entry price and may lead to the recognition of “Day one” gains and losses. IAS 39 states that an entity would recognise a gain or loss upon initial recognition if, and only if, the fair value is based solely on observable market data. This is a significant difference from SFAS 157, which does not require the use of observable market data in order to recognise a “Day one” gain or loss.

The IASB has not reached a preliminary view on the immediate recognition of “Day one” gains and losses, but has discussed the following two views:

- Maintain the current requirements in IAS 39.
- Recognise gains or losses immediately upon initial recognition because the concept of exit price in determining fair value should be applied consistently.

### Response to IASB

The IASB has invited comments on any aspect of the discussion paper by 2 April 2007.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms’ offices.

### Figure 1

#### Level Description

- | Level | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|-------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1     | Fair value is determined based on quoted market prices in an active market. The total fair value of a portfolio of assets or liabilities (including a block) is not adjusted for the number of instruments compared to the trading volume. Fair value must be determined on a unit-by-unit basis.                                                                                                                                                                                                                                                                                                 |
| 2     | In determining fair value, information other than the quoted market prices in an active market is used, including: <ul style="list-style-type: none"><li>• quoted market prices for similar assets, liabilities or equity instruments in active markets</li><li>• quoted market prices for identical or similar assets, liabilities or equity instruments in markets that are not active</li><li>• observable market information other than quoted market prices</li><li>• information derived mainly from, or corroborated by, observable market data by correlation or other methods.</li></ul> |
| 3     | Fair value is determined using unobservable market data. The data must reflect the conditions and assumptions that are applied by market participants when determining the exit price for assets, liabilities or equity instruments. Therefore an entity is not allowed to use entity-specific assumptions or information.                                                                                                                                                                                                                                                                        |

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