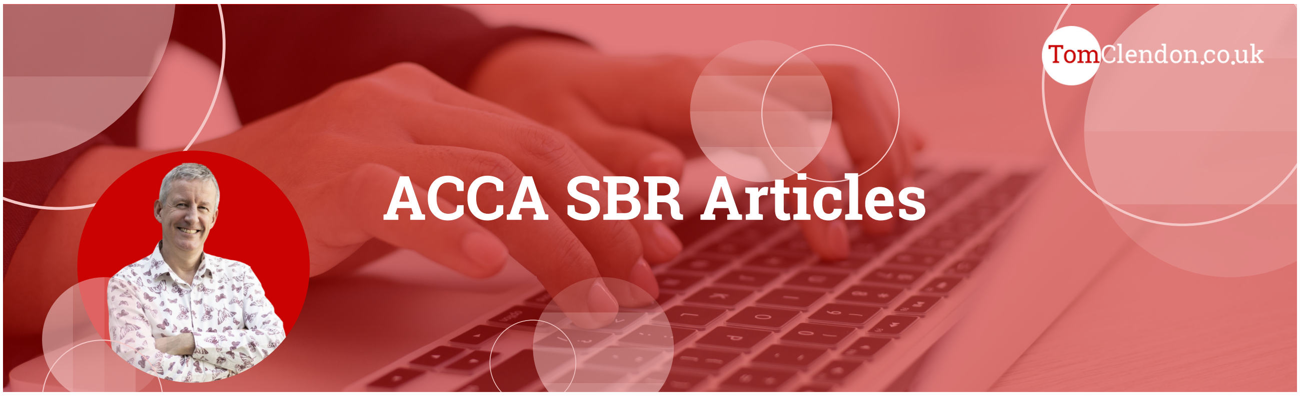

IFRS 13, Fair Value Measurement

IFRS 13 has required a significant amount of work by entities to simply understand the nature of the principles and concepts involved.

IFRS® 13, *Fair Value Measurement* was issued in May 2011 and defines fair value, establishes a framework for measuring fair value and requires significant disclosures relating to fair value measurement. The International Accounting Standards Board (the Board) wanted to enhance disclosures for fair value in order that users could better assess the valuation techniques and inputs that are used to measure fair value. There are no new requirements as to when fair value accounting is required but rather it relies on guidance regarding fair value measurements in existing standards.

The guidance in IFRS 13 does not apply to transactions dealt with by certain standards. For example share based payment transactions in IFRS 2, *Share-based Payment*, leasing transactions in IFRS 16, *Leases*, or to measurements that are similar to fair value but are not fair value – for example, net realisable value calculations in IAS® 2, *Inventories* or value in use calculations in IAS 36, *Impairment of Assets*. Therefore, IFRS 13 applies to fair value measurements that are required or permitted by those standards not scoped out by IFRS 13. It replaces the inconsistent guidance found in various IFRS standards with a single source of guidance on measurement of fair value.

Historically, fair value has had a different meaning depending on the context and usage. The Board's definition of 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. Basically it is an exit price. Consequently, fair value is focused on the assumptions of the market place, is not entity specific and so takes into account any assumptions about risk. This means that fair value is measured using the same assumptions used by market participants and takes into account the same characteristics of the asset or liability. Such conditions would include the condition and location of the asset and any restrictions on its sale or use.

Interestingly an entity cannot argue that prices are too low relative to its own valuation of the asset and that it would be unwilling to sell at low prices. The prices to be used are those in 'an orderly transaction'. An orderly transaction is one that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities to take place and to ensure that it is not a forced transaction. If the transaction is not 'orderly' then there will not have been enough time to create competition and potential buyers may reduce the price that they are willing to pay. Similarly if a seller is forced to accept a price in a short period of time, the price may not be representative. Therefore, it does not follow that a market in which there are few transactions is not orderly. If there has been competitive tension, sufficient time and information about the asset, then this may result in an acceptable fair value.

IFRS 13 does not specify the unit of account that should be used to measure fair value. This means that it is left to the individual standard to determine the unit of account for fair value measurement. A unit of account is the single asset or liability or group of assets or liabilities. The characteristic of an asset or liability must be distinguished from a characteristic arising from the holding of an asset or liability by an entity. An example of this is where an entity sells a large block of shares, and it has to sell them at a discount price to the market price. This is a characteristic of holding the asset rather than a characteristic of the asset itself and should not be taken into account when fair valuing the asset.

Fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The principal market is the one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

The most advantageous market is the one, which maximises the amount that would be received for the asset or paid to extinguish the liability after transport and transaction costs. Often these markets would be the same.

Sensibly an entity does not have to carry out an exhaustive search to identify either market but should take into account all available information. Although transaction costs are taken into account when identifying the most advantageous market, the fair value is calculated before adjustment for transaction costs because these costs are characteristics of the transaction and not the asset or liability. However, if location is a factor, then the market price is adjusted for the costs incurred to transport the asset to that market. Market participants must be independent of each other and knowledgeable, and able and willing to enter into transactions.

This is a complex process and so IFRS 13 sets out a valuation approach, which refers to a broad range of techniques, which can be used. There are three approaches based on the market, income and cost. When measuring fair value, the entity is required to maximise the use of observable inputs and minimise the use of unobservable inputs. To this end, the standard introduces a fair value hierarchy, which prioritises the inputs into the fair value measurement process

Fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used, as follows:

- Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset or liability being measured. As with current IFRS standards, if there is a quoted price in an active market, an entity uses that price without adjustment when measuring fair value. An example of this would be prices quoted on a stock exchange. The entity needs

to be able to access the market at the measurement date. Active markets are ones where transactions take place with sufficient frequency and volume for pricing information to be provided. An alternative method may be used where it is expedient. The standard sets out certain criteria where this may be applicable. For example where the price quoted in an active market does not represent fair value at the measurement date. An example of this may be where a significant event takes place after the close of the market such as a business reorganisation or combination.
  The determination of whether a fair value measurement is based on level 2 or level 3 inputs depends on
  - (i) whether the inputs are observable inputs or unobservable and
  - (ii) their significance.
- Level 2 inputs are inputs other than the quoted prices in determined in level 1 that are directly or indirectly observable for that asset or liability. They are likely to be quoted assets or liabilities for similar items in active markets or supported by market data. For example interest rates, credit spreads or yields curves. Adjustments may be needed to level 2 inputs and, if this adjustment is significant, then it may require the fair value to be classified as level 3.
- Finally, level 3 inputs are unobservable inputs. These inputs should be used only when it is not possible to use Level 1 or 2 inputs. The entity should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. However, situations may occur where relevant inputs are not observable and therefore these inputs must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability. The general principle of using an exit price remains and IFRS 13 does not preclude an entity from using its own data. For example cash flow forecasts may be used to value an entity that is not listed. Each fair value measurement is categorised based on the lowest level input that is significant to it.

IFRS 13 also sets out certain valuation concepts to assist in the determination of fair value. For non-financial assets only, fair value is determined based on the highest and best use of the asset as determined by a market participant. Highest and best use is a valuation concept that considers how market participants would use a non-financial asset to maximise its benefit or value. The maximum value of a non-financial asset to market participants may come from its use in combination with other assets and liabilities or on a standalone basis. In determining the highest and best use of a non-financial asset, IFRS 13 indicates that all uses that are physically possible, legally permissible and financially feasible should be considered. As such, when assessing alternative uses, entities should consider the physical characteristics of the asset, any legal restrictions on its use and whether the value generated provides an adequate investment return for market participants.

The fair value measurement of a liability, or the entity's own equity, assumes that it is transferred to a market participant at the measurement date. In many cases there is no observable market to provide pricing information and the highest and best use is not applicable. In this case, the fair value is based on the perspective of a market participant who holds the identical instrument as an asset. If there is no corresponding asset, then a corresponding valuation technique may be used. This would be the case with a decommissioning activity. The fair value of a liability reflects the non performance risk based on the entity's own credit standing plus any compensation for risk and profit margin that a market participant might require to undertake the activity. Transaction price is not always the best indicator of fair value at recognition because entry and exit prices are conceptually different.

The guidance includes enhanced disclosure requirements that include:

- information about the hierarchy level into which fair value measurements fall
- transfers between levels 1 and 2
- methods and inputs to the fair value measurements and changes in valuation techniques, and
- additional disclosures for level 3 measurements that include a reconciliation of opening and closing balances, and quantitative information about unobservable inputs and assumptions used.

The above is a snapshot of a standard, which has required a significant amount of work by entities to simply understand the nature of the principles and concepts involved.

Written by a member of the *Strategic Business Reporting* examining team.

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