Clearly IFRS

Summary guidance and practical tips for IFRS 13 – Fair Value Measurement

It will soon be time for many Canadian entities to file their first annual financial statements which incorporate the adoption of IFRS 13 – Fair Value Measurement (IFRS 13). IFRS 13 is a standard which has broad application and the extent of the impact it has may not be fully evidenced or appreciated until the first annual financial statements which reflect the adoption of the standard. The interim reports under IFRS 13 required only a sub-set of the full IFRS 13 disclosures and many entities may not have dealt with the application of the guidance on non-recurring fair value measurements. This may prove to be complex.

This publication is not intended to address comprehensively all of the detailed requirements of IFRS 13 but rather has been developed with a view to providing a refresher of the key concepts and requirements of the IFRS 13 so as to assist entities in their year-end reporting requirements. Details of how and where to access our model financial statements and IFRS checklists are provided later in this tipsheet.

I hope you find this summary guidance helpful for your reporting requirements.

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National Director of Accounting Services

Definition of 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.

Many other IFRSs require or permit the use of fair value but prior to IFRS 13 there was no single definition or framework to be applied. IFRS 13 removes this inconsistency through a single definition to be applied to all fair value measurements and disclosures. The 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”.

The “When” and “How” of fair value measurement

When to fair value: The “When” IFRSs are the primary IFRSs applicable to an account balance or transaction. For example, the “when” IFRS for a financial asset would be IAS 39 or IFRS 9 and the “when” IFRS for an asset classified as held for sale would be IFRS 5. Other examples are IFRS 3, IFRS 6, IAS 19 and IAS 40.

How to fair value: IFRS 13 is the “How” IFRS to be applied when another IFRS requires or permits fair value measurement or disclosure. The application of IFRS 13 does, in places, refer back to the “when” IFRSs. For example, in the determination of the unit of account or in the assessment of whether a fair value measurement is recurring or non-recurring. IFRS 13 cannot function in isolation – rather, it acts as a companion standard to the other IFRSs.

In terms of where to start in the determination of fair value, it is useful to consider three broad steps that should be taken before delving into the details that inevitably will follow. These steps are important in illustrating the relationship between the primary IFRS that dictates when fair value measurement is required and IFRS 13 which is the “how” IFRS.

Step 1: Identify the balance or transaction that must (may) be measured or disclosed at fair value and when such measurement (disclosure) is necessary.

Step 2: Consult IFRS 13 for guidance on how to determine fair value upon initial recognition.

Step 3: Consult the “when” IFRS to determine if the subsequent measurement of the account balance is at fair value and/or if fair value disclosures are required.
How to determine fair value – key considerations

Once you have established the item that is the subject of fair value measurement (and/or disclosure), the nuts and bolts of IFRS 13 come into play. The standard could appear overwhelming – it is comprised of 99 paragraphs of core guidance plus a further 47 paragraphs of application guidance (Appendix B to IFRS 13). As you get more familiar with the standard any fear of fair value will likely subside. In the meantime, the table which follows sets out a summary of the key considerations in how to determine fair value under IFRS 13.

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<th>IFRS 13 requirement</th>
<th>Our insights</th>
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<td><strong>Unit of account</strong> – The determination of the unit of account must be established prior to determining fair value and is defined as the level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.</td>
<td>• The item for which fair value is determined may be a single asset or liability such as a derivative instrument or a share in a publicly traded entity or it may be a group of assets (i.e. a portfolio of receivables), group of liabilities (i.e. a portfolio of deposits) or group of assets and liabilities (e.g. a cash-generating unit, a business or an asset group which is held for sale). • IFRS 13 does not generally provide specific guidance on the determination of the unit of the account – rather it directs preparers to other IFRSs to make this determination. IFRS 13 does specifically address one area relating to the unit of account in the form of guidance for financial assets and financial liabilities with offsetting positions. Here IFRS 13 includes a “portfolio exception” allowing a specified level of grouping when a portfolio of financial assets and financial liabilities are managed together with offsetting markets risks or counterparty credit risk. This exception is subject to your entity meeting certain eligibility criteria. (IFRS 13.48-52).</td>
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<td><strong>Market</strong> – Fair value measurement under IFRS 13 assumes that a transaction to sell an asset or to transfer a liability takes place in the principal market (or the most advantageous market in the absence of the principal market). The principal market is the market with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.</td>
<td>• If there is a principal market, the price in that market must be used, either directly or as an input into a valuation technique. IFRS 13 does not permit the use of a price in the most advantageous market if a principal market price is available! • This said, it is not necessary to perform an exhaustive search of all possible markets to identify the principal market (or, in the absence of a principal market, the most advantageous market). However, all information that is reasonably available should be considered and the basis for your conclusions should be documented. • There is a presumption in the standard that the market in which the entity normally transacts to sell the asset or transfer the liability is the principal or most advantageous market unless there is evidence to the contrary. • Where your entity transacts in various markets (such as when assets are sold on multiple commodity and/or equity exchanges), your entity should document which particular market price is used and what process was followed to determine the appropriate market to use for determining fair value.</td>
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<td><strong>Market participant assumptions</strong> – A fair value measurement under IFRS 13 requires an entity to consider the assumptions a market participant, acting in their economic best interest, would use when pricing the asset or a liability. Market participants are defined as having the following characteristics: • Independent of each other (i.e. unrelated parties). • Knowledgable and using all available information. • Able of entering into the transaction. • Willing to enter into the transaction (i.e. not a forced transaction).</td>
<td>• The key concept here is that the standard requires your entity to put itself in the place of a market participant and exclude any entity-specific factors that might impact the price that your entity is willing to accept in the sale of an asset or be paid in the transfer of a liability. • So, for example, relevant characteristics of an asset might include or relate to: – The condition and location of the asset; and – Restrictions, if any, on the sale or use of the asset. • Here, you would need to consider the extent to which a market participant would take the above characteristics into account when pricing the asset or liability at the measurement date. The extent to which restrictions on the sale or use of the asset should be reflected in fair value are very much contingent on where the source of the restriction comes from and whether or not the restriction is separable from the asset. • Depending on the particular item that is the subject of the fair value measurement, the analysis of determining exactly what a market participant would consider may, in some cases, prove to be challenging. As such, in more challenging cases, we would recommend consultation with your auditors and advisors.</td>
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<td><strong>Inputs and valuation techniques</strong> – IFRS 13 does not mandate the use of a particular valuation technique(s) but sets out a principle requiring an entity to determine a valuation technique that is “appropriate in the circumstances”, for which sufficient data is available and for which the use of relevant observable inputs is maximized. IFRS 13 discusses three widely used valuation techniques which are: • The market approach • The cost approach • The income approach</td>
<td>• IFRS 13 is clear that the valuation technique your entity uses must maximize the use of relevant observable inputs and minimize the use of unobservable inputs. For example, if a quoted price is available for a specific asset, this price must be used instead of an entity-specific assumption about the price. • Further, there is a direct correlation between the level of disclosures required and the level of unobservable inputs – the more the degree of unobservable data used in your valuation technique, the more the degree of disclosure that you must include in your financial statements. • A change in a valuation technique can be made but only if the change results in a measurement that is equally or more representative of fair value. Any such change, where justified, is considered to be a change in estimate (IFRS 13.66).</td>
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Special considerations - non-financial assets, liabilities and own equity instruments

Layered within the requirements of IFRS 13 are specific considerations related to certain elements of the financial statements. These considerations effectively add an additional dimension to the base requirements of the standard.

Non-financial assets (such as items within the scope of IAS 36, IAS 40 and IFRS 5) are subject to a valuation premise referred to as the "highest and best use". This requires that fair value be determined based on the highest and best use of the asset from the perspective of a market-participant.

- The measurement of non-financial assets at the highest and best use is a significant change from previous guidance and requires judgment to be applied.
- Highest and best use must meet certain criterion and barriers limiting the assets ability should be examined to ensure that the asset’s use is:
  - Physically possible - Are there any issues with the location or size of the property?
  - Legally permissible - Are there any zoning implications restricting use?
  - Financially feasible - Will the use generate adequate cash flows to produce a return acceptable by market participants?

An entity can presume that the current use of an asset is its highest and best use. However, if the asset is being used defensively (e.g. to protect a competitive position), this presumption may be inappropriate.

Liabilities and own equity instruments must be measured on the assumption that the liability or equity is transferred to a market participant at the measurement date. This differs (sometimes significantly so) from a measurement that is based on the assumption of settlement of a liability or cancellation of an entity’s own equity instrument.

IFRS 13 further requires that the fair value of a liability must factor in non-performance risk. Anything that could influence the likelihood of an obligation being fulfilled is considered a non-performance risk. This could include the risk of physically extracting or transporting an asset or the entity’s own credit risk.

It is important to recognize that the specific approach to fair value liabilities and an entity’s own equity instruments sometimes differs from the concepts to fair value an asset. This is summarizes in the decision tree that accompanies this text.

Pressure points

In today’s financial reporting environment, no IFRS is static. The issuance of other new standards and interpretations can at times prompt a review of aspects of the guidance. Further, it is only after the initial implementation and application of a new standard that some of the practical or interpretative issues are encountered. Two examples of practical application issues that we have encountered in our work on IFRS 13 are below. Consultation with your auditors and advisors is recommended in these circumstances and, of course, it is important to monitor developments through resources provided by Deloitte as well as the websites of both the Canadian and International Accounting Standards Board (see links at the end of the document).

- Determination of fair value of a publicly quoted associate, subsidiary or joint arrangement: This issue relates to whether or not the determination of fair value in this circumstance can incorporate any adjustments to the quoted price (such as control premiums). More guidance on this issue is expected in 2014.

- Business combinations involving shares with a trading restriction: In Canada, it is common for publicly-traded entities to pay for acquisitions using shares and in some cases there may be a restriction attached to the shares either through legend or through a separate agreement. A careful assessment of the nature of the restriction will be required to determine the appropriate accounting under IFRS 13.
Disclosure considerations and additional resources

The disclosure requirements of IFRS 13 are intended to provide users of financial statements with information about the valuation techniques and inputs used to develop fair value measurements and how fair value measurements using significant unobservable inputs impacted performance for the period. IFRS 13 requires extensive disclosures about fair value measurements. New items of significance include:

- Qualitative disclosure requirements for recurring and non-recurring fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy that include a description of the valuation technique(s) and the inputs used in the fair value measurement.
- Quantitative and qualitative disclosures based on the three-level fair value hierarchy are extended to cover non-financial assets when they are measured at fair value.

IFRS 13 covers the disclosures after initial recognition on the basis that other IFRSs address the disclosure of fair values at initial recognition (for example IFRS 3 sets out disclosure requirements for the fair value measurements of the net assets acquired in a business combination). The level of disclosures required by IFRS 13 depends on whether the fair value measurement is recurring or non-recurring subsequent to initial recognition. Recurring fair value measurements relate to those where measurement is required at the end of each reporting period-end in comparison to non-recurring measurements which are driven by a particular event or transaction. Recurring measurements would include a policy choice under IAS 40 or IAS 16 to record property at fair value or available for sale or fair value through profit or loss financial instruments classification. Non-recurring measurements arise due to a period specific event such as a held for sale classification under IFRS 5 or financial or non-financial instrument impairments where the asset is written down to fair value. While many of the disclosure requirements are the same, the recurring disclosures include additional requirements applicable to the continuous nature of the fair value measurement requirement.

The table below provides a synopsis of the fair value disclosure requirements for recurring, non-recurring and disclosure only items. Model financial statements (incorporating IFRS 13) and a compliance, presentation and disclosure checklist are available on iasplus.com through this link: http://www.corpgov.deloitte.com/site/CanEng/self-assessments-tools-and-other-resources/financial-reporting-tools/.

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<th>Non-recurring measurements</th>
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<tr>
<td>FV measurement at end of reporting period</td>
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<tr>
<td>Reasons for the FV measurement</td>
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<td>Level within FV hierarchy (1, 2, 3)</td>
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<tr>
<td>Transfers between L1 and L2 with reasons</td>
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<tr>
<td>Description of valuation technique (L2, L3)</td>
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<tr>
<td>Quantified unobservable inputs (L3)</td>
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<td>Description of valuation processes used (L3)</td>
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<td>Description of sensitivity to changes in unobservable inputs (L3)</td>
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<tr>
<td>Quantification of sensitivity to changes in unobservable inputs (L3)</td>
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Level 1 inputs – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
Level 2 inputs – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3 inputs – Unobservable inputs for the asset or liability.

Other useful websites
Canadian Accounting Standards Board: www.frascanada.ca
IFRS Discussion Group - Search topics by issue at: www.frascanada.ca/international-financial-reporting-standards/ifrs-discussion-group/search-past-meeting-topics/item66541.aspx
International Accounting Standards Board: www.ifrs.org

www.deloitte.ca

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