IFRS Global office
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# IFRS in Focus
# IASB issues new standard on fair value measurement and disclosure

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www.iasplus.com

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**The Bottom Line**

- IFRS 13 establishes a single framework for measuring fair value where that is required by other Standards. The Standard applies to both financial and non-financial items measured at fair value.
- Fair value is defined 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" (i.e., an exit price).
- IFRS 13 is effective for annual periods beginning on or after 1 January 2013, with early adoption permitted, and applies prospectively from the beginning of the annual period in which the Standard is adopted.

## Introduction

On 12 May 2011, the International Accounting Standards Board (IASB) issued IFRS 13 *Fair Value Measurement*, which establishes a single source of guidance for fair value measurement under IFRSs.

IFRS 13 defines fair value, provides guidance on its determination and introduces consistent requirements for disclosures on fair value measurements. The Standard does not include requirements on when fair value measurement is required; it prescribes how fair value is to be measured if another Standard requires it.

Some Standards (for example, IAS 40 *Investment Property*) require items to be measured at fair value on an ongoing basis (IFRS 13 refers to this as 'fair value on a recurring basis'), some (for example, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*) require fair value only in certain circumstances (IFRS 13 refers to this as 'fair value on a non-recurring basis) and some (for example, IFRS 3 *Business Combinations*) require fair value only on initial recognition of an item.

## Scope

IFRS 13 applies to all transactions and balances (whether financial or non-financial) for which IFRSs require or permit fair value measurements, with the exception of share-based payment transactions accounted for under IFRS 2 *Share-based Payment* and leasing transactions within the scope of IAS 17 *Leases*.

The Standard also makes clear that measurements that have some similarities to fair value but that are not fair value, such as net realisable value under IAS 2 Inventories or value in use under IAS 36 *Impairment of Assets*, are not within its scope.

IFRS 13 gives relief from its disclosure requirements in respect of the following items:

- Plan assets measured at fair value in accordance with IAS 19 *Employee Benefits*.

- Retirement benefit plan investments measured at fair value in accordance with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*.

- Assets for which the recoverable amount is fair value less costs of disposal in accordance with IAS 36 *Impairment of Assets*.

### Definition of 'fair value'

The Standard 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." This is sometimes referred to as an 'exit price'.

### Determination of fair value

IFRS 13 indicates that an entity must determine the following to arrive at an appropriate measure of fair value:

- The asset or liability being measured (consistent with its unit of account).

- The principal (or most advantageous) market in which an orderly transaction would take place for the asset or liability.

- For a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets or on a stand-alone basis. The appropriate valuation technique(s) for the entity to use when measuring fair value, focusing on inputs a market participant would use when pricing the asset or liability.

- Those assumptions that market participants would use when pricing the asset or liability.

*Principal (or most advantageous) market*

Fair value is the price that would be achieved if an asset were sold (or liability transferred) to a market participant in the principal market (i.e., the market with the greatest volume and level of activity for that asset or liability). If there is no principal market, the price in the most advantageous market (i.e., the market in which the entity could achieve the most beneficial price) is used.

In the absence of evidence to the contrary, the market in which the entity normally transacts would be presumed to be the principal or most advantageous market. If location is a characteristic of an asset, the price should be adjusted for costs that would be incurred to transport the asset to or from the principal (or most advantageous) market. However, transaction costs would not be included in a fair value measurement because such costs are not a characteristic of the asset or liability.

*Highest and best use*

The fair value of a non-financial asset is measured on the basis of the highest and best use of the asset by a market participant. In determining the highest and best use, an entity must contemplate whether the use of the asset is "physically possible, legally permissible, and financially feasible." Unless market or other factors suggest otherwise, an entity's current use of a non-financial asset is presumed to be its highest and best use.

Some entities may purposefully decide not to employ an asset at its highest and best use (e.g., when an entity holds an asset defensively to prevent others from using it). In such circumstances, IFRS 13 continues to require measurement based on the highest and best use and also requires disclosure of the fact that the asset is not used in that way.

In circumstances in which the highest and best use of an asset is in combination with an asset group (e.g., a business) but the unit of account is the individual asset, the fair value of that asset would be measured under the assumption that a market participant has, or can obtain, the complementary assets or liabilities.

*Liabilities and own equity*

The fair value of a liability or equity instrument of the entity is determined under the assumption that the instrument would be transferred on the measurement date, but would remain outstanding (i.e., it is a transfer value, not an extinguishment or settlement cost).

The Standard provides a hierarchy of methods for arriving at this value, stating that when a quoted price for the transfer of the liability or equity is not available, the fair value of the liability or equity instrument from the perspective of a market participant holding the item as an asset is used in preference to a value determined using a valuation technique.

Regardless of the method used, the fair value of a liability must take account of non-performance risk – including the entity's own credit risk.

*Offsetting market risks or counterparty credit risk*
The Standard allows a limited exception to the basic fair value measurement principles for a reporting entity that holds a group of financial assets and financial liabilities with offsetting positions in particular market risks as defined in IFRS 7 *Financial Instruments: Disclosures* or counterparty credit risk (also as defined in IFRS 7) and manages those holdings on the basis of the entity's net exposure to either risk. This exception allows the reporting entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position.

**Observations**
The measurement of the fair value of a portfolio of financial assets and financial liabilities on the basis of net exposure does not affect the financial statement presentation of these instruments. The requirements of other IFRSs on offsetting assets and liabilities must still be met in order to present a net position. If those requirements are not met, and hence the assets and liabilities are presented on a gross basis, an entity should allocate any ortfolio-level adjustments to the individual assets and liabilities "on a reasonable and consistent basis using a methodology appropriate in the circumstances."

Note that the IASB issued its exposure draft ED/2011/01 *Offsetting Financial Assets and Financial Liabilities* on 28 January 2011. This ED would provide clarifying guidance in applying the current offsetting principles in IAS 32 and proposes additional qualitative and quantitative disclosures about financial assets and financial liabilities subject to offsetting. For more information about the ED, see Deloitte's February 2011 IFRS in Focus.

When an entity has elected a policy to apply the exception to a portfolio in which the market risks being offset are **substantially the same**, the entity should apply the price within the bid-ask spread that is most representative of fair value to the entity's net exposure to those market risks.

The Standard also indicates that when netting credit risk exposures with a particular counterparty in a fair value measurement, the entity should consider whether market participants would take into account any existing arrangements that mitigate risk exposure (e.g., a master netting agreement) in the event of default.

### Valuation techniques
When transactions are directly observable in a market, the determination of fair value can be relatively straightforward, but when they are not, a valuation technique is used. IFRS 13 describes three valuation techniques an entity might use to determine fair value.

- **The market approach** – An entity "uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets, liabilities or a group of assets and liabilities."

- **The income approach** – An entity converts future amounts (e.g., cash flows or income and expenses) to a single current (i.e., discounted) amount.

- **The cost approach** – An entity determines a value which "reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)."

A valuation technique should be selected, and consistently applied, to maximise the use of relevant observable inputs (and minimise unobservable inputs).

*Premiums and discounts*
The Standard permits a premium or a discount to be included in a fair value measurement only when it is consistent with the unit of account for the item. This means that premiums or discounts that reflect size as a characteristic of the entity's holding (e.g., a blockage factor reducing the price which could be achieved on disposal of an entire large equity holding) rather than as a characteristic of the asset or liability (e.g., a control premium when measuring the fair value of a controlling interest) are not included.

**Observations**
Unit of account guidance is outside the scope of IFRS 13. Therefore, entities should look to other IFRSs for unit of account guidance.

*Fair Value at initial recognition*

If the transaction price for an item is determined to be its fair value at that date, then any valuation technique utilising unobservable inputs must be calibrated to show that fair value at initial recognition, thus ensuring that future remeasurements reflect only changes in value subsequent to initial recognition.

If, on the other hand, the fair value at initial recognition differs from the transaction price the resulting gain or loss must be recognized in profit or loss unless another IFRS specifies a different treatment. For financial assets or financial liabilities, both IFRS 9 and IAS 39 specify how to account for a difference between the initial fair value and the transaction price.

## Disclosures

IFRS 13 requires a number of quantitative and qualitative disclosures about fair value measurements. Many of these are related to the following three-level fair value hierarchy on the basis of the inputs to the valuation technique:

- Level 1inputs are fully observable (e.g., unadjusted quoted prices in an active market for identical assets and liabilities that the entity can access at the measurement date);

- Level 2 inputs are those other than quoted prices within Level 1 that are directly or indirectly observable; and

- Level 3 inputs are unobservable.

An asset or liability is included in its entirety in one of the three levels on the basis of the lowest-level input that is significant to its valuation.

Disclosures based on this hierarchy are already required for financial instruments under IFRS 7, but IFRS 13 extends them to cover all assets and liabilities within its scope. Required disclosures are highlighted in the table below.

Some disclosure requirements differ depending on whether the fair value calculation is performed on a recurring or non-recurring basis. IFRS 13 defines recurring and non-recurring fair value measurements of assets and liabilities as follows:

- Recurring – those that other IFRSs require or permit in the statement of financial position at the end of each reporting period.

- Non-recurring – those that other IFRSs require or permit in the statement of financial position in particular circumstances.

| | For assets and liabilities measured at fair value in the statement of financial position after initial recognition | | |
|---|---|---|---|
| Required disclosure | Recurring | Non-recurring | Disclosed at fair value in the footnotes to the financial statements |
| The fair value at the reporting date | ✓ | ✓ | ✓ |
| The reason it is measured at fair value | | ✓ | |
| The level in the three level fair value hierarchy | ✓ | ✓ | ✓ |
| The amounts of transfers between Levels 1 and 2, the reasons for those transfers, and the entity's policy for determining when transfers between levels are deemed to have occurred | ✓ | | |
| For Levels 2 and 3 a description of the valuation technique(s) and inputs used | ✓ | ✓ | ✓ |
| For Level 2 and 3 fair value measurements for which there has been a change in valuation technique, disclose the change and the reason(s) for making it | ✓ | ✓ | ✓ |
| If the highest and best use of an nonfinancial asset differs from its current use, disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use | ✓ | ✓ | ✓ |
| Information sufficient to permit reconciliation between the disclosure of classes of assets and liabilities by fair value hierarchy and the line items presented in the statement of financial position | ✓ | ✓ | |

| Required disclosure | For assets and liabilities measured at fair value in the statement of financial position after initial recognition | | Disclosed at fair value in the footnotes to the financial statements |
|---|---|---|---|
| | Recurring | Non-recurring | |
| If an entity makes an accounting policy decision to use the exception in paragraph 46 (see Offsetting discussion within this In Focus), disclose that fact | ✓ | ✓ | |
| For a liability measured at fair value, disclose the existence of any credit enhancement and whether it is reflected in the fair value measurement of the liability | ✓ | ✓ | |
| **The following disclosure requirements apply to fair value measurements using significant unobservable inputs (Level 3)** | | | |
| Quantitative information about the significant unobservable inputs used in the fair value measurement (see Appendix A for an example of this quantitative disclosure requirement) | ✓ | ✓ | |
| A reconciliation of the opening and closing balances with separate disclosure of (i) amounts in profit or loss (and line item in which they are recognized), (ii) amounts in other comprehensive income, (iii) amounts of purchases, sales, issues and settlements (each type separately), and (iv) and the amounts of any transfers in or out of Level 3 (including the reasons for those transfers, and the entity's policy for determining when transfers between levels are deemed to have occurred) | ✓ | | |
| The amount of total gains or losses for the period included in profit or loss that is attributable to the change in unrealised gains or losses for those assets and liabilities held at the reporting date and the line item(s) in which the gains or losses are recognised | ✓ | | |
| Description of the valuations processes including for example how an entity decides its valuation policies and procedures and analyses changes in fair value from period to period | ✓ | ✓ | |
| Narrative description of the sensitivity of fair value to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement and a description of the interrelationships between unobservable inputs including how such interrelationship might magnify or mitigate the impact to fair value from changes in such inputs | ✓ | | |
| For financial assets and financial liabilities, when a change in one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall disclose that fact, the effect of those changes, and how the effect of the change is calculated | ✓ | | |

## Effective date and transition

IFRS 13 is effective for annual periods beginning on or after 1 January 2013. Early application is permitted. Therefore, entities are allowed to apply the measurement and disclosure requirements as soon as practicable. Entities that choose to adopt the standard early should disclose that fact.

IFRS 13 should be applied prospectively from the beginning of the annual period in which it is adopted.

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