

FAIR VALUE MEASUREMENT UNDER IFRS 13



The term 'fair value' is the subject of a lot of debate in the media these days. **John McCarroll** and **Goind Ram Khatri** look at some of the practical aspects of recent changes in the guidance on fair value measurement and related disclosures.

Guidance on 'fair value' under the existing International Financial Reporting Standards (IFRS) is covered by a number of different standards. Recently, the International Accounting Standards Board (IASB) issued a new accounting standard, IFRS 13 *Fair value measurement* which establishes a single source of guidance for fair value measurement where fair value is required or permitted under IFRS. This article looks at some of the practical considerations relevant for first-time application of the standard.

WHAT IS 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". The fair value definition is based on four key elements, illustrated in *Figure 1*.

WHAT HAS CHANGED?

The standard introduces changes in the different items that are fair valued and disclosed in the financial statements. Some of those changes are set out below.

Bid, ask or mid quoted prices

Under the existing guidance in IAS 39, where a financial instrument is quoted in an active market the appropriate price to

measure the instrument is usually bid price for a financial asset and ask price for a financial liability.

IFRS 13 requires the use of a price within the bid-ask spread that is most representative of fair value in the circumstances.

The use of bid prices for asset positions and ask prices for liability positions is also permitted, but is not required under IFRS 13. *Example 1* illustrates the application of these changes for funds.

Financial liabilities and own credit risk

Under IFRS 13, the fair value of a financial liability is the cost to transfer it to another market participant in an orderly transaction at the measurement date. This is subtly different to how the fair value of a financial liability is determined under the previous rules in IAS 39 where the fair value of a financial liability is the amount at which it could be settled between knowledgeable, willing parties in an arm's-length transaction.

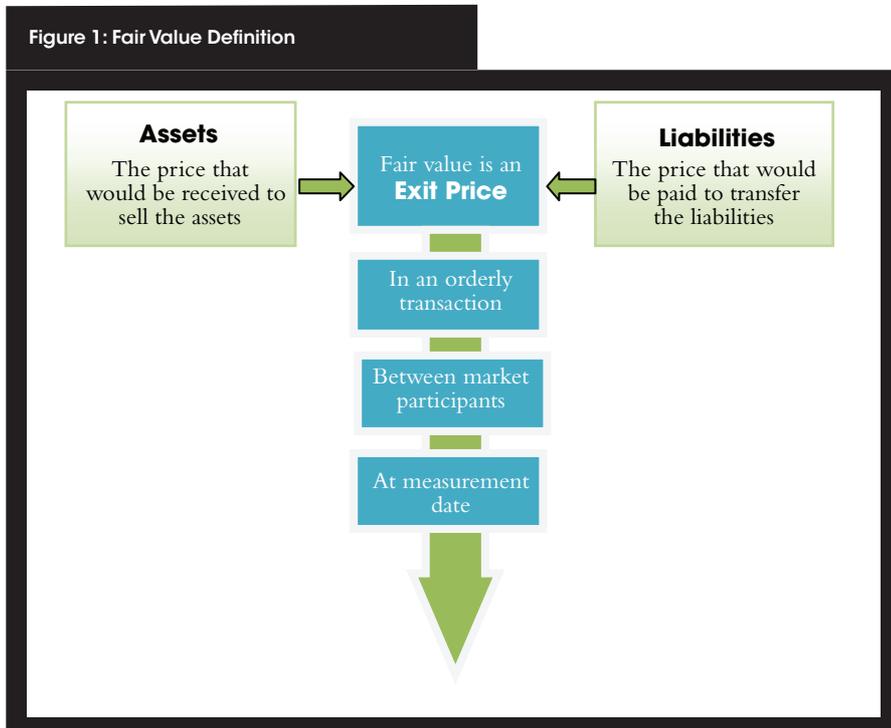
Example 1

Universal Fund Limited has an investment in equity securities. The Offering Document of the fund requires the use of 'last price' to arrive at dealing NAV. As IAS 39 requires the use of 'bid price' for assets, therefore the dealing NAV is adjusted by measuring investment portfolio at bid price to arrive at reporting NAV. However, under IFRS 13 no adjustment is required as long as last price falls between bid and ask prices.

Example 2

An entity owns a factory property which is accounted for using the revaluation model under IAS 16 property, plant and equipment. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. Taking into account all available market and other factors the company determined that the highest and best possible use of the site is to use it for developing a high-rise apartment building.

Figure 1: Fair Value Definition



The amount at which an entity can settle a financial liability with the counterparty is sometimes argued to be different to the amount at which the same liability could be transferred to another market participant. The transfer notion for a financial liability can seem abstract at times, particularly because in many cases such a transfer is not legally permissible under the terms of contract.

However, new guidance makes clear that any legal restriction on transfer should be ignored and the valuation is based on the assumption that the liability would remain outstanding after the transfer and the credit risk before and after would remain the same. In essence this means that own credit risk must be incorporated into the valuation.

Consideration of credit risk also applies to other financial liabilities such as derivatives liabilities. For derivative liabilities, the valuation could be more complex, not least because of the lack of observable data on the price of credit for over-the-counter derivatives.

Furthermore, capturing changes in credit risk in the valuation of derivative liabilities designated as hedging instruments could impact the effectiveness of those hedging relationships and in some cases could potentially lead to hedge accounting failures.

Portfolio level valuation methodologies

If certain criteria are met, IFRS 13 allows measuring the fair value on a net basis in a portfolio of assets with offsetting market risks or counterparty credit risks.

This is an exception to the general fair value model in IFRS 13 and an accounting policy choice available only if the portfolio is managed and reported to key management personnel on a net risk basis in accordance with a documented strategy. Hence if an entity anticipates using such an exception it will need to carefully assess whether it meets the conditions in the standard.

Fair value of non-financial assets

One of the fundamental changes in IFRS 13 is the way non-financial assets are currently fair valued. The standard requires that a fair value measurement of a non-financial asset should take into account a market participant's ability to generate economic benefits by using the asset in its highest and best possible use or by selling it to another market participant that would use the asset in its highest and best possible use.

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible.

Example 2 illustrates the concept of the highest and best possible use.

Disclosure requirements for financial and non-financial items

The standard requires a number of quantitative and qualitative disclosures relating to the following three-level fair value hierarchy on the basis of the inputs to the valuation technique:

- Level 1 inputs 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. Most of the companies operating in the financial services sector should be well aware of the disclosure requirements but those in the non-financial sector would probably need substantial work in this area.

CONCLUSION

The standard is effective for annual periods beginning on or after 1 January 2013 subject to the endorsement by the EU. Although this is some way off, the effect of the new requirements will need to be planned for in terms of valuation processes and controls and analysing the impact on the resulting numbers and any knock-on effects such as hedge accounting. While it is likely that the financial services sector will be the most impacted, this new standard could have significant implications for any entity that carries a financial or non-financial asset at fair value. ■

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