IFRS 13 – FAIR VALUE MEASUREMENT

WHY IFRS 13?

The objectives of IFRS 13 are:

1. To define fair value;
2. To set out in a single IFRS a framework for measuring fair value; and
3. To require disclosures about fair value measurements.

IFRS 13 – FAIR VALUE MEASUREMENT

- Fair value is a ***market-based*** measurement, not an entity-specific measurement. It means that an entity:

- Shall look at how the ***market participants*** would look at the asset or liability under measurement and shall not take own approach (e.g. use) into account.

This is the notion of an ***exit price***.

WHAT IS FAIR VALUE?

- Fair value is the price that would be received to sell an asset or paid to transfer a liability (*exit price*) in an orderly transaction (*not a forced sale*) between market participants (*market-based view*) at the measurement date (*current price*)

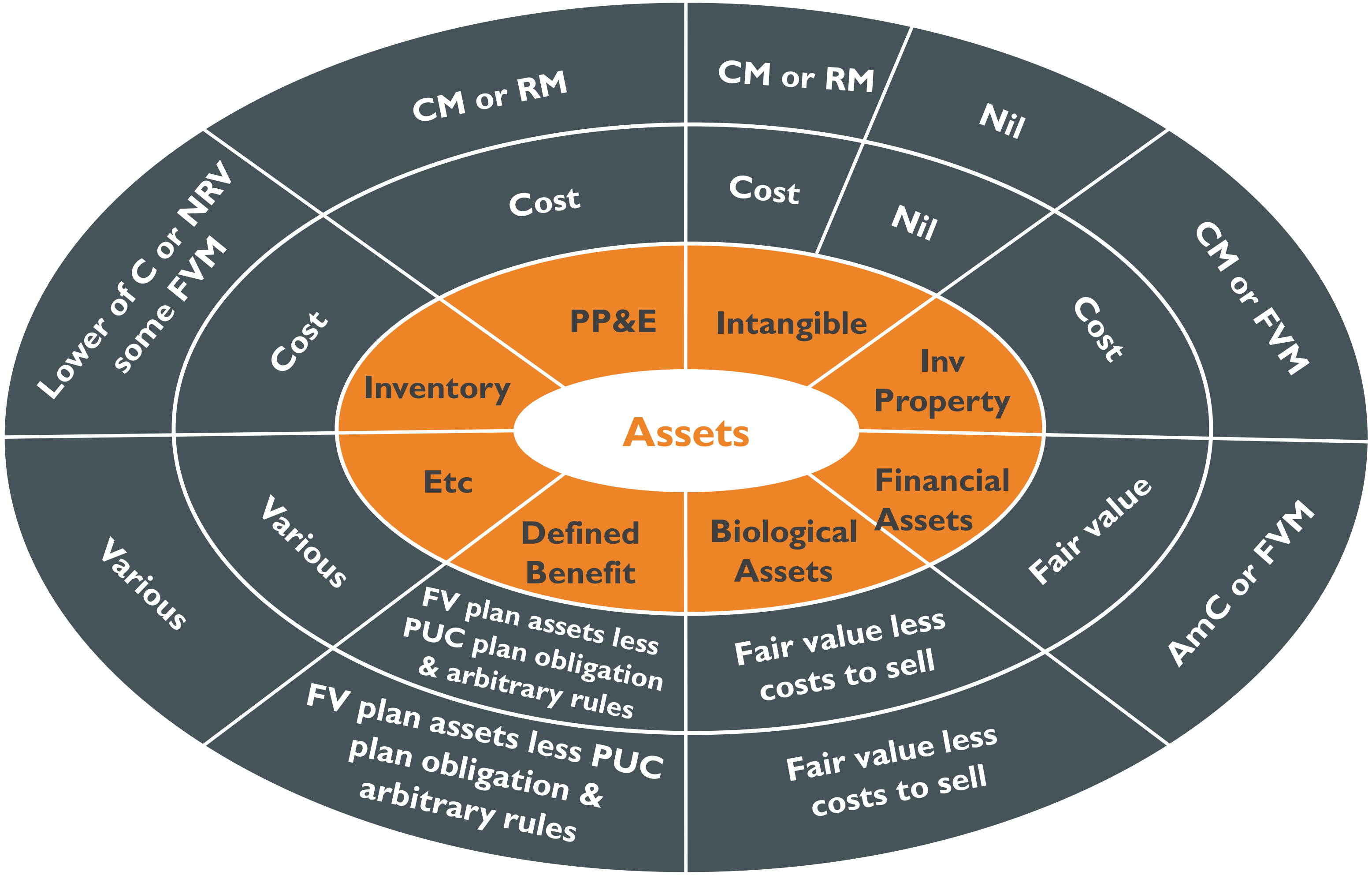
- Fair value is a market-based measurement (it is not an entity-specific measurement)

- Consequently, the entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

THE OLD DEFINITION OF FAIR VALUE

The old definition of fair value	Its weaknesses
The amount for which an asset could be **exchanged**, or a liability **settled**, between **knowledgeable, willing parties** in an arm's length transaction.	It did not specify whether an entity is **buying or selling** the asset.
	It was unclear about what **settling** meant because it did not refer to the creditor.
	It was unclear about whether it was **market-based**.
?	It did not state explicitly **when** the exchange or settlement takes place.

CLASSIFICATION, RECOGNITION AND MEASUREMENT



ASSET TYPE	MEASUREMENT AT INITIAL RECOGNITION	MODEL BASED ON FAIR VALUE	BASIS OF IMPAIRMENT TEST
IFRS 9 *Financial Instruments*	**Fair value**	For specified financial assets and for particular business models: **fair value**	
IAS 16 *Property, Plant and Equipment*	Purchase costs + construction costs + costs to bring to the location and condition necessary to be capable of operating in the manner intended by management.	Accounting policy choice: **revaluation model**	Compare carrying amount to recoverable amount. Recoverable amount is greater of value in use and fair value less disposal costs (IAS 36)
IAS 38 *Intangible Assets*	Purchase costs + development costs + costs to bring to the location and condition necessary to be capable of operating as intended by management	Accounting policy choice: **revaluation model**	
IAS 40 *Investment Property*	Cost including transaction costs	Accounting policy choice: **fair value**	
IAS 41 *Agriculture*	**Fair value** less costs to sell	**Fair value** less costs to sell	

IFRS 13

When an entity performs the fair value measurement, it must determine all of the following:

- The particular ***asset or liability*** that is the subject of the measurement (consistently with its unit of account) For a ***non-financial asset*,** the ***valuation premise*** that is appropriate for the measurement **(consistently with its highest and best use)**
- The ***principal or Most advantageous market*** for the asset or liability
- V***aluation techniques*** appropriate for the measurement, considering:
- ***Availability of data*** with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability;
- ***Fair value hierarchy*** within which the inputs are categorized.

ASSET OR LIABILITY

The asset or liability measured at fair value might be either:

1. a ***stand-alone*** (individual) asset or liability (for example, a share or a pizza oven)
2. a ***group*** of assets, a group of liabilities, or a group of assets and liabilities

When measuring fair value, an entity takes into account the ***characteristics*** of the asset or liability that a market participant would take into account when pricing the asset or liability at measurement date. These characteristics include for example:

a) the ***condition and location*** of the asset

b) the ***restrictions*** on the sale or use of the asset.

TRANSACTION

- A fair value measurement assumes that the asset or liability is exchanged in an ***orderly transaction*** between ***market participants*** at the measurement date under current market conditions.

The transaction is ***orderly*** when 2 key components are present:

1. there is adequate market exposure in order to provide market participants the ability to obtain knowledge and awareness of the asset or liability necessary for a market-based exchange
2. market participants are motivated to transact for the asset or liability (not forced).

MARKET PARTICIPANTS

Market participants are buyers and sellers in the principal or the most advantageous market for the asset or liability, with the following characteristics:

1. Independent
2. Knowledgeable
3. Able to enter into transaction
4. Willing to enter into transaction.

PRINCIPAL VERSUS MOST ADVANTAGEOUS MARKETS

Principal market is the market with the greatest volume and level of activity for the asset or liability. Different entities can have different principal markets, as the access of an entity to some market can be restricted (please watch the video below for deeper explanation).

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.

APPLICATION TO NON-FINANCIAL ASSETS

Fair value of a non-financial asset shall be measured based on its ***highest and best use*** from a market participant's perspective. The highest and best use takes into account the use of the asset that is:

1. ***physically possible*** – it takes into account the physical characteristics that market participants would consider (for example, property location or size);
2. ***legally permissible*** – it takes into account the legal restrictions on use of the asset that market participants would consider (for example, zoning regulations); or
3. ***financially feasible*** – it takes into account whether a use of the asset generates adequate income or cash flows to produce an investment return that market participants would require. This should incorporate the costs of converting the asset to that use.

APPLICATION TO FINANCIAL LIABILITIES AND OWN EQUITY INSTRUMENTS

- A fair value measurement of a financial or non-financial liability or an entity's own equity instruments assumes it is ***transferred*** to a market participant at the measurement date, without settlement, extinguishment, or cancellation at the measurement date.
- In the first instance, an entity shall set the fair value of the liability or equity instrument by the reference to the ***quoted market price*** of the identical instrument, if available.
- If the quoted price of identical instrument is ***not available***, then the fair value measurement depends on whether the liability or equity instrument ***is held by other parties as assets or not:***

If the liability or equity instrument *is held* by other party as an asset, then

1. If there is the quoted price in an active market for the identical instrument held by another party, then use it (adjustments are possible for the factors specific for the asset, but not for the liability/equity instrument)
2. If there is no quoted price in an active market for the identical instrument held by another party, then use other observable inputs or another valuation technique

If the liability or equity instrument ***is not held*** by other party as an asset, then use a valuation technique from the perspective of market participant

FAIR VALUE HIERARCHY

Is there a quoted price in an active market for an identical asset or liability? (Level 1 input)

Yes

Use the Level 1 input = **Level 1 measurement**

Must use without adjustment

No

Are there any observable inputs* other than quoted prices for an identical asset or liability?

Yes

No use of significant unobservable (Level 3) inputs‡ = **Level 2 measurement**

No

Use of significant unobservable (Level 3) inputs‡ = **Level 3 measurement**

* Maximise the use of *relevant* observable inputs. Observable inputs include market data (prices and other information) that is publicly available

‡ Unobservable inputs include the entity's own data (eg budgets, forecasts), which must be adjusted if market participants would use different assumptions

LEVELS OF INPUT

- ***Level 1*** inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- ***Level 2*** inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Quoted prices of identical assets or liabilities in active or inactive markets
- ***Level 3*** inputs are unobservable inputs for the asset or liability. Financial forecasts and historical volatility

NON-PERFORMANCE RISK

- The fair value of a liability reflects the effect of ***non-performance risk*** – the risk that an entity will not fulfill its obligation.
- Non-performance risk includes, but is not limited to an ***entity's own credit risk***.
- For example the risk of non-performance can be reflected in the different borrowing rates for different borrowers due to their different credit rating. As a result, they would need to discount the same amount with the different discount rate, thus the present value of a liability would differ.

TRANSFER RESTRICTIONS AND DEMAND FEATURE

Transfer restrictions - An entity shall ***not include*** a separate input or an adjustment to other inputs relating to the potential restriction preventing the transfer of the item to somebody else.

Demand feature - The fair value of a ***liability with a demand feature*** is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid.

FAIR VALUE AT INITIAL RECOGNITION

- When an entity acquires an asset or assumes a liability, the price paid/received or the ***transaction price is an entry price***.
- However, IFRS 13 defines fair value as the price that would be received to sell the asset or paid to transfer the liability and that's ***an exit price***.
- In most cases, transaction or entry price equals to exit price or fair value. But there are some situations when transaction price is not necessarily the same as exit price or fair value:

1. The transaction happens between ***related parties***
2. The transaction takes place ***under duress*** or the seller is forced to accept the price in the transaction
3. The ***unit of account*** represented by the transaction price is ***different*** from the unit of account for the asset or liability measured at fair value
4. The ***market*** in which the transaction takes place is ***different*** from principal or the most advantageous market.

If the transaction price differs from the fair value, then an entity shall recognize the resulting gain or loss ("***Day 1 profit***") to profit or loss unless another IFRS standard specifies other treatment.

VALUATION TECHNIQUES

When determining fair value, an entity shall use valuation techniques:

1. Appropriate in the circumstances
2. For which sufficient data are available to measure fair value
3. Maximizing the use of relevant observable inputs
4. Minimizing the use of unobservable inputs.
5. Valuation techniques used to measure fair value shall be applied ***consistently***.

3 VALUATION APPROACHES

1. ***Market approach:*** uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities, or a group of assets and liabilities, such as a business

2. ***Cost approach:*** reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

3. ***Income approach:*** converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

FAIR VALUE HIERARCHY

- IFRS 13 introduces a ***fair value hierarchy*** that categorizes inputs to valuation techniques into 3 levels.
- The highest priority is given to Level 1 inputs and the lowest priority to Level 3 inputs.
- An entity must ***maximize the use of Level 1*** inputs and ***minimize the use of Level 3 inputs***.

DISCLOSURE

IFRS 13 requires ***extensive disclosure*** of sufficient information to asses:

1. ***Valuation techniques and inputs used*** to develop fair value measurement for both recurring and non-recurring measurements;
2. ***The effect of measurements*** on profit or loss or other comprehensive income for recurring fair value measurements using significant Level 3 inputs.
3. ***Recurring*** fair value measurements are those presented in the statement of financial position at the end of each reporting period (for example, financial instruments).
4. ***Non-recurring*** fair value measurements are those presented in the statement of financial position in particular circumstances (for example, an asset held for sale in line with IFRS 5).

DISCLOSURE

- Fair value measurement at the end of the reporting period;
- The reasons for measurement (for non-recurring)
- The level in which they are categorized in the fair value hierarchy,
- Description of valuation techniques and inputs used;
- And many others.

FINANCIAL ASSETS AND FINANCIAL LIABILITIES WITH OFFSETTING POSITIONS

- IFRS 13 requires a market-based measurement, not for an entity-based measurement. However, there is an exception to this rule:
- If an entity manages a ***group*** of financial assets and financial liabilities ***on the basis of its NET exposure*** to market risks or counterparty risks, an entity can opt to measure the fair value of that group on the net basis, and that is:
- The price that would be received ***to sell a net long position*** (asset) for particular risk exposure, or
- The price that would be paid ***to transfer a net short position*** (liability) for particular risk exposure.

This is an ***option*** and an entity does not necessarily need to follow it. In order to apply this exception, an entity must fulfill the following conditions:

FINANCIAL ASSETS AND FINANCIAL LIABILITIES WITH OFFSETTING POSITIONS

This is an ***option*** and an entity does not necessarily need to follow it. In order to apply this exception, an entity must fulfill the following conditions:

1. It must manage the group of financial assets/liabilities based on its net exposure to market/credit risk according to its ***documented risk management or investment strategy***,
2. It provides information on that basis about the group of financial assets/liabilities to ***key management personnel***,
3. It measures those financial assets and liabilities ***at fair value*** in the statement of financial position at the end of each reporting period (so not at amortized cost, or other measurement basis).