IFRS 13 Fair Value Measurement

Introduction

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, also referred to as the willing buyer-willing seller principle. It is important to note that fair value is a market-based measurement and not an entity-specific measurement.

This guidance paper expands on the concept of fair value, provides some theoretical information to the valuation techniques prescribed in IFRS 13 Fair Value Measurement and highlights some common misinterpretations of the Standard.

This guidance paper should be read with the IFRS Summary – IFRS 13 Fair Value Measurement, which is available on http://www.pkf.com/ifrs or, for PKF member firms, from PKF365.

Effective date and transition

An entity shall apply this Standard for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies this IFRS for an earlier period, it shall disclose that fact.

This Standard shall be applied prospectively as of the beginning of the annual period in which it is initially applied.

Amendment from Annual Improvements Cycle 2011–2013 issued in December 2013: An entity shall apply that amendment for annual periods beginning on or after 1 July 2014. An entity shall apply that amendment prospectively from the beginning of the annual period in which IFRS 13 Fair Value Measurement was initially applied. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

Understanding the fair value concept

When determining fair value of an asset or liability, cognisance must be given to what the market participants would consider when determining an appropriate price to pay or receive for that asset or liability.

Matters that market participants would consider include the condition and location of the asset as well as the restrictions on the sale or use of the asset.

This Standard is very clear that transaction costs should not be included in the fair value of the asset or liability as these costs are not a characteristic of the asset or liability, however the fair value must be adjusted to consider any transport costs.

Generally, the fair value of non-financial assets proves to be the most difficult to determine, given the fact that it may be difficult to determine the correct market as well as the characteristics that market participants would consider when determining an acceptable price. The Standard states that the fair value of non-financial assets must be determined regarding the highest and best use of the asset, even when the counter-party to the transaction will not use the asset in the same manner as the seller. However, the seller’s current use of the asset is the highest and best use of the asset.

When performing the fair value calculation, entities must use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.
To increase the consistency and comparability in fair value measurements and related disclosures, this Standard established a fair value hierarchy that categorises the inputs to valuation techniques into three levels:

- **Level 1**: Quoted (unadjusted) market prices in active markets for identical assets or liabilities
- **Level 2**: Valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable
- **Level 3**: Valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable

This Standard requires entities to apply valuation techniques consistent with any of the following three methods:

### Cost approach

The 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).

From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives). In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.

### Market approach

The market approach 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, such as a business.

For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement.

Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities’ relationship to other benchmark quoted securities.

### Income approach

The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

Those valuation techniques include, for example, the following:

(a) present value techniques;
(b) option pricing models, such as the Black-Scholes-Merton formula or a binomial model (i.e. a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and
(c) the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.
Practical guidance

Determining the fair value of a financial asset or liability can be a complicated process. The following illustrations highlight some of the more common misinterpretations when applying the requirements of IFRS 13, especially regarding categorisation into the fair value hierarchy. They address aspects of IFRS 13 but are not intended to provide interpretative guidance.

Intangible assets

Generally, intangible assets cannot be traded in an active market. An active market is defined as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. Based on this, the sale (and purchase) of intangible assets should be at the very least categorised as a level 2 fair value measurement. Further to this, the disclosure required will most likely only be included on the acquisition date as subsequent to purchase, the asset would be measured at cost (less accumulated amortisation and impairment).

Debt instruments

Debt issuers must consider the extent of actively trading in an active market; if trade is not active, it is incorrect to classify their own debt instruments as being with the level 1 hierarchy.

Investment properties

The inputs used to determine fair value of investment properties are often not observable, in which case they cannot be included in the level 2 hierarchy. Observable inputs are defined as inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

Operational financial instruments

Operational financial instruments, such as trade receivables and trade payables, finance leases, loans receivable and loans payable, cannot be included in the level 2 hierarchy due to the inputs not being observable.

Interim financial statements

Entities that are required to prepare interim statements in accordance with IAS 34 Interim Financial Reporting are reminded that the disclosure requirements contained in IFRS 13 Fair Value Measurement are also required in the interim statements, where items are measured at fair value and the fair values of those items were also determined at the interim period.

Conclusion

IFRS 13 Fair Value Measurement is a single source of fair value measurement guidance that clarifies the definition of fair value, provides a clear framework for measuring fair value and enhances the disclosures about fair value measurements. It is also the result of the efforts of the IASB and the FASB to ensure that fair value has the same meaning in IFRSs and in US GAAP and that their respective fair value measurement and disclosure requirements are the same (except for minor differences in wording and style). IFRS 13 Fair Value Measurement applies to IFRSs that require or permit fair value measurements or disclosures. It does not introduce new fair value measurements, nor does it eliminate practicability exceptions to fair value measurements.

In other words, IFRS 13 Fair Value Measurement specifies how an entity should measure fair value and disclose information about fair value measurements. It does not specify when an entity should measure an asset, a liability or its own equity instrument at fair value.