IN THE HEADLINES
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Unified fair value measurement and disclosure guidance for IFRS

IFRS 13 *Fair Value Measurement* that was issued on 12 May 2011 defines fair value, establishes a framework for measuring fair value and sets out disclosure requirements for fair value measurements. IFRS 13 explains how to measure fair value when it is required by other IFRSs. It does not introduce new fair value measurements, nor does it eliminate the practicability exceptions to fair value measurements that currently exist in certain standards. Prior to the introduction of IFRS 13 there was no single source of guidance on fair value measurement and inconsistencies in guidance added to the complexity of financial reporting.

Key points to note:

- Fair value defined as an exit price
- Comprehensive framework for measuring fair value when such measurement is required under other IFRSs
- Additional disclosures required about fair value measurements, including for non-financial assets and liabilities

Our forthcoming publication *First Impressions: Fair value measurement* will provide more details about the new requirements and discuss possible application issues. Speak to your usual KPMG contact if you would like copies.

Key principles and requirements

The following table provides an overview of the key principles and requirements of IFRS 13.

Area	Key principles and requirements
General principles	• Fair value is an exit price • Measurement considers characteristics of the asset or liability and not entity-specific characteristics • Measurement assumes a transaction in the entity's principal (or most advantageous) market between market participants • Price is not adjusted for transaction costs • Measurement maximises the use of relevant observable inputs and minimises the use of unobservable inputs • Three-level fair value hierarchy is extended to all fair value measurements
Specific application principles	• Non-financial assets – measurement is based on highest and best use • Financial assets and liabilities with offsetting risks – allows measurement of net exposures in limited circumstances • Liabilities and an entity's own equity instruments – quoted prices are used if available; if not, then quoted prices for an identical item held as an asset are used before resorting to other valuation techniques
Disclosures	• Fair value hierarchy disclosures are extended to non-financial assets and liabilities measured at fair value • Information about non-recurring fair value measurements introduced • Effect on profit or loss for recurring fair value measurements categorised within Level 3 • Information about fair value disclosed for items not measured at fair value but for which fair value is disclosed • More detail in interim financial statements for fair value of financial instruments
Other	• Leases and share-based payments are out of the scope of IFRS 13, as is the determination of value in use for impairment testing and net realisable value for inventories • The standard is applied prospectively from 1 January 2013 • Early application is permitted

The definition of fair value in IFRS 13 is identical to that in US Accounting Standard Codification Topic 820 *Fair Value Measurements and Disclosures* (Topic 820), which was amended on the same day that IFRS 13 was issued. The guidance in IFRS 13 is also largely consistent with Topic 820, although certain, relatively minor differences exist.

General principles

Definition of fair value

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, i.e. an exit price.

The asset or liability

A fair value measurement considers the characteristics of the asset or liability, e.g. the condition and location of the asset and restrictions, if any, on its sale or use, if market participants would consider those characteristics when determining the price of the asset or liability at the measurement date. With very limited exceptions discussed below, the unit of account, e.g. a single asset or liability or a group of assets or liabilities, is not specified. Instead, the unit of account used for fair value measurement is determined under the particular standard giving rise to the requirement to measure fair value.

The transaction

A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions. The hypothetical transaction is considered from the perspective of a market participant that holds the asset or owes the liability, i.e. it does not consider entity-specific factors that might influence an actual transaction. Therefore, the entity's intention or ability to enter into a transaction on that date is not relevant.

An *orderly transaction* is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction, e.g. a forced liquidation or distress sale.

The hypothetical transaction to sell the asset or transfer the liability is assumed to take place in the *principal market*. This is the market with the greatest volume and level of activity for the asset or liability. In the absence of a principal market, the transaction is assumed to take place in the *most advantageous market*. This is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs. Because different entities, and different businesses within a single entity, may have access to different markets, the principal or most advantageous market for the same asset or liability may vary from one entity to another, or between businesses within an entity.

Market participants

Fair value measurement uses assumptions that market participants would use in pricing the asset or liability. *Market participants* are buyers and sellers in the principal (or most advantageous) market who are independent of each other, knowledgeable about the asset or liability, and willing and able to enter into a transaction for the asset or liability.

The price

Fair value is the price that would apply in a transaction between market participants whether it is observable in an active market or estimated using a valuation technique.

The price is not adjusted for transaction costs because these costs are not a characteristic of the asset or liability; they are a characteristic of the transaction. However, transaction costs are considered when determining the most advantageous market (see above). Transaction costs do not include the costs of transporting the asset to or from its principal (or most advantageous) market. If location is a characteristic of an asset, e.g. a commodity, then the price is adjusted for any costs that would be incurred to transport the asset to or from that market.

Fair value hierarchy

An entity applies the fair value hierarchy that was introduced by IFRS 7 *Financial Instruments: Disclosures* to all fair value measurements. The fair value hierarchy gives highest priority to Level 1 inputs and the lowest priority to Level 3 inputs. *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. *Level 3 inputs* are inputs for the asset or liability that are not based on observable market data, i.e. unobservable inputs.

A fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

Valuation techniques

The objective of using a valuation technique is to determine the price at which an orderly transaction would take place between market participants at the measurement date. An entity uses valuation techniques that are appropriate in the circumstances and for which sufficient data are available, maximising the use of relevant observable inputs and minimising the use of unobservable inputs. Under IFRS 13 three valuation approaches: income, market and cost are identified.

Inputs into valuation techniques

When selecting the inputs into a valuation technique, an entity selects inputs that are consistent with the characteristics that market participants would take into account in a transaction. A premium or discount, such as a control premium or a discount for lack of control, may be appropriate if it would be considered by market participants in pricing the asset or liability based on the unit of account.

If the inputs are determined based on bid and ask prices, then an entity uses the price in the bid-ask spread that is most representative of fair value, irrespective of the level in the hierarchy. The use of bid prices for long positions (assets) and ask prices for short positions (liabilities) is permitted but not required.

Using quoted prices provided by third parties

It is not precluded to use quoted prices provided by third parties, such as brokers or pricing services, provided that the prices are determined in accordance with the guidance on fair value measurements in IFRS 13. Whether those prices represent observable or unobservable inputs and the weight attached to them in measuring fair value depends on their nature or source.

Markets that are not active and transactions that are not orderly

An entity evaluates the significance and relevance of factors described in IFRS 13 to determine whether, based on the evidence available, there has been a significant decrease in the volume or level of activity. However, even if a market is not active, it is not appropriate to conclude that all transactions in that market are not orderly, i.e. are forced or distress sales.

Quoted prices derived from a market that is not active may not be determinative of fair value. In such circumstances, further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transaction or quoted prices may be necessary to measure fair value.

Specific application principles

Highest and best use and valuation premises for non-financial assets

A fair value measurement considers a market participant's ability to generate economic benefits by using the asset or by selling it to another market participant who will use the asset in its highest and best use. *Highest and best* use refers to the use of an asset that would maximise the value of the asset, considering uses of the asset that are physically possible, legally permissible and financially feasible.

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use, e.g. an entity may intend to use assets acquired in a business combination differently from other market participants. However, an entity need not perform an exhaustive search for other potential uses if there is no evidence to suggest that the current use of an asset is not its highest and best use.

The highest and best use of an asset establishes the following valuation premises for the fair value of that asset.

- **In combination.** If an asset would provide maximum value to market participants principally through its use in combination with other assets and liabilities as a group, then the fair value of the asset is measured on the basis of the price that would be received in a current transaction to sell the asset assuming that:
  - the asset would be used with other assets and liabilities as a group; and
  - the complementary assets and liabilities would be available to market participants.
- **Stand-alone.** If an asset would provide maximum value to market participants principally on a stand-alone basis, then its fair value is the price that would be received in a current transaction to sell the asset to market participants who would use it on a stand-alone basis.

Both the in-combination and the stand-alone valuation premises assume that the asset is sold individually, i.e. not as part of a group of assets or a business.

The highest and best use concept is not relevant for financial assets and liabilities.

Offsetting positions in market risks or counterparty credit risk

If an entity manages a group of financial assets and liabilities that are measured at fair value on the basis of its net exposure to market or credit risks, then it is permitted to measure the fair value of the group on the basis of its net exposures to particular risks if this is in accordance with its documented strategy and information is reported on this basis to its key management personnel.

The use of this exception is an accounting policy decision. Under the exception, fair value would be determined consistently with how market participants would price the net risk exposure. In particular, market risk exposures would be offset only to the extent that they are substantially the same as to their nature and duration and that any basis risk is taken into account. Net credit risk exposures would consider arrangements that mitigate credit exposure in the event of default if and to the extent that market participants would take them into account.

Liabilities and equity instruments

The fair value of a liability or an entity's own equity instruments is measured using quoted prices for the transfer of identical or similar instruments. When such prices are not available, an entity measures fair value from the perspective of a market participant holding the identical item as an asset. If quoted prices in an active market for the corresponding asset are also not available, then other observable inputs are used, such as prices in an inactive market for the asset. Otherwise, an entity uses a valuation technique(s), e.g. a present value measurement or the pricing of a similar liability or instrument.

The fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation, e.g. own credit risk. If an inseparable third-party credit enhancement is accounted for separately from a liability, then it is disregarded in measuring the liability's fair value.

IFRS 13 retains the principle in IAS 39 *Financial Instruments: Recognition and Measurement* that the fair value of a financial liability with a demand feature is not less than the present value of the amount payable on demand.

Fair value at initial recognition

The price paid in a transaction to acquire an asset or received to assume a liability, often referred to as the 'entry price', may or may not equal the fair value of that asset or liability based on an exit price. If an entity is required or permitted to measure an asset or liability initially at fair value under an IFRS and the transaction price differs from fair value, then the entity recognises the resulting gain or loss in profit or loss at the transaction date unless otherwise required by the specific IFRS. Therefore, the recognition of a 'day one' gain or loss when the transaction price differs from the fair value is determined by the particular standard that prescribes the accounting for the asset or liability.

There is no substantive change in the existing guidance in IAS 39 with respect to the recognition of a day one gain or loss on a financial instrument. Therefore, similar to the current requirements under IAS 39, an entity does not recognise a day one gain or loss for a financial instrument based on a difference between the transaction price and its fair value unless its fair value is evidenced by a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only data from observable markets.

In determining whether fair value at initial recognition equals the transaction price, an entity considers factors specific to the transaction and the asset or liability. For example, the transaction price is often the best evidence of the fair value of an asset or liability at initial recognition unless:

- the transaction is between related parties;
- the transaction takes place under duress;
- 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, for example, the transaction price includes the purchase of other items or transaction costs; or
- the market in which the transaction takes place is different from the principal, or most advantageous, market.

Disclosures

An extensive disclosure framework in IFRS 13 combines the disclosures currently required by IFRSs and US Topic 820 with additional disclosures that users of financial statements have suggested would be useful. The objectives of the disclosures are to provide information that enables financial statement users to assess the methods and inputs used to develop fair value measurements and, for recurring fair value measurements that use significant unobservable (Level 3) inputs, the effect of the measurements on profit or loss or other comprehensive income.

To meet these objectives, an entity provides certain minimum disclosures for each class of asset and/or liability. For non-financial assets and non-financial liabilities that are measured at fair value or based on fair value in the statement of financial position, an entity provides fair value disclosures that are similar to existing fair value disclosures for financial assets and financial liabilities in IFRS 7. This disclosure is also required for non-recurring fair value measurements, e.g. an asset held for sale. The requirement to disclose a fair value hierarchy and information on valuation techniques is also extended to assets and liabilities that are not measured at fair value in the statement of financial position but for which fair value is disclosed pursuant to another standard. If an entity uses an asset in a way that differs from the highest and best use of the asset, then an entity discloses the reasons why the asset is used in a manner that differs from its highest and best use.

In addition, an entity discloses a description of the valuation processes used by the entity for measurements categorised within Level 3. This includes, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period. An entity discloses a narrative description of the sensitivity of Level 3 measurements to changes in unobservable inputs, including the effect of any interrelationships between unobservable inputs, as well as quantitative information on significant unobservable inputs used in measuring fair value.

For financial instruments, fair value disclosures required in annual financial statements also apply for interim financial reports. For non-financial assets and non-financial liabilities, no additional fair value disclosure requirements are required beyond the existing requirements in IAS 34 *Interim Financial Reporting*.

Other issues

Scope and objective

IFRS 13 applies to assets, liabilities and an entity's own equity instruments that, under other IFRSs, are required or permitted to be measured at fair value or when disclosure of fair values is provided. It does not apply to share-based payment transactions within the scope of IFRS 2 *Share-based Payment* and leasing transactions within the scope of IAS 17 *Leases*. These standards still refer to their measurement requirements as fair value. However, both standards have been amended to clarify that for items within their scope, the term 'fair value' is applied based on guidance in the respective standard rather than based on the guidance in IFRS 13. IFRS 13 also does not apply to measurements that are similar to but not fair value, e.g. net realisable value or value in use.

Effective date and transition

The following diagram shows the transition requirements for an entity with a 31 December annual reporting date that does not choose to adopt IFRS 13 early, which is permitted.

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