# HOW TO MEASURE FAIR VALUE

http://www.accaglobal.co.uk/en/redirect-pages/CPD---A1-How-to-measure-fair-value.html

The IASB's IFRS13 standard offers guidance for determining exactly what constitutes the fair value of an asset or liability, and how entities should go about measuring it

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The International Accounting Standards Board (IASB) has recently completed a joint project with the Financial Accounting Standards Board (FASB) on fair value measurement. The result is IFRS 13, *Fair Value Measurement*. The standard defines fair value, establishes a framework for measuring it, and requires significant disclosures relating to it. The IASB wanted to enhance disclosures for fair value so that users could better assess the valuation techniques and inputs used to measure it. There are no new requirements in IFRS 13 about when fair value accounting is required - the IASB is relying on guidance on fair value measurements in existing standards. Although IFRS 13 moves International Financial Reporting Standards (IFRS) and US GAAP closer on how to measure fair value, differences remain about when fair value measurements are required and the recognition of gains or losses on initial recognition.

The guidance in IFRS 13 does not apply to transactions dealt with by certain standards (such as share-based payment transactions in IFRS 2, Share-based Payment, and leasing transactions in IAS 17, *Leases*) nor to measurements that are similar to fair value but are not fair value (such as net realisable value calculations in IAS 2, Inventories, or value in use calculations in IAS 36, *Impairment of Assets*).

IFRS 13 applies therefore to fair value measurements that are required or permitted by those standards not scoped out by IFRS 13. It replaces the inconsistent guidance found in various IFRSs with a single source of guidance on measurement of fair value, and has an effective date of 1 January 2013. The standard is applied prospectively and can be adopted early.

## THE EXIT PRICE

Fair value has a different meaning depending on the context and usage. The IASB's definition of 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. In other words, it is an exit price.

Fair value is focused on the assumptions of the marketplace and is not entity-specific. It therefore takes into account any assumptions about risk. It is measured using the same assumptions and taking into account the same characteristics of the asset or liability as market participants would. Such characteristics include the condition and location of the asset and any restrictions on its sale or use.

The basic principles thus remain similar to current IFRS, but if an entity did not use these principles before IFRS 13, it could result in significant change. For example, if an entity's view of fair value did not take into account the highest and best use of the asset when revaluing its property, plant and equipment, then IFRS 13 could result in a higher fair value.

It is not a relevant argument in the valuation process for the entity to insist that prices are too low relative to its own valuation of the asset and that it would be unwilling to sell at such low prices. The prices to be used are those in 'an orderly transaction' - one that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities and to ensure that it is not a forced transaction.

If the transaction is not 'orderly' there will not have been enough time to create competition, and potential buyers may reduce the price that they are willing to pay. Similarly, if a seller is forced to accept a price in a short period of time, then the price may not be representative.

However, it does not follow that a market with few transactions is not an orderly one. If there has been competitive price tension, and sufficient time and information about the asset, then the market may return a fair value for the asset.

## UNIT OF ACCOUNT

The unit of account to be employed for measuring fair value is not specified by IFRS 13, but is determined by the individual standard. A 'unit of account' is the single asset or liability or a group of assets or liabilities.

The characteristic of an asset or liability must be distinguished from a characteristic arising from the holding of an asset or liability by an entity. An example is where an entity has to sell a large block of shares at a discount to the market price. This discount is a characteristic of holding the asset rather than of the asset itself and should not be taken into account when fair-valuing the asset.

## WHICH MARKET?

Fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The principal market is the one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

The most advantageous market is the one that maximises the amount that would be received for the asset or paid to extinguish the liability after transport and transaction costs. Often these markets would be the same.

Sensibly, an entity does not have to carry out an exhaustive search to identify either market but should take into account all available information. Although transaction costs are taken into account when identifying the most advantageous market, the fair value is not after adjustment for transaction costs because these costs are a characteristic of the transaction, not the asset or liability.

If location is a factor, then the market price is adjusted for the costs incurred to transport the asset to that market. Market participants must be independent of each other and knowledgeable, and able and willing to enter into transactions.

IFRS 13 sets out a valuation approach that refers to a broad range of techniques. These techniques are threefold: the market, income and cost approaches.

When measuring fair value, the entity is required to maximise the use of observable inputs and minimise the use of unobservable inputs. To this end, the standard introduces a fair value hierarchy, which prioritises the inputs into the fair value measurement process.

Fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used, as follows.

## INPUT HIERARCHY

**Level 1** inputs are unadjusted quoted prices in active markets for items identical to the asset or liability being measured. As with current IFRS, if there is a quoted price in an active market, an entity uses that price without adjustment when measuring fair value. An example of this would be prices quoted on a stock exchange. The entity needs to be able to access the market at the measurement date.

Active markets are ones where transactions take place with sufficient frequency and volume for pricing information to be provided. An alternative method may be used where it is expedient, and the standard sets out criteria where this may be applicable.

For example, it may be that the price quoted in an active market does not represent fair value at the measurement date, a situation which may occur when a significant event such as a business reorganisation or combination takes place after the close of the market.

Determining whether a fair value measurement is a level 2 or level 3 input depends on whether the inputs are observable or unobservable, and on their significance.

**Level 2** inputs are inputs other than quoted prices in level 1 that are observable for that asset or liability. They are quoted assets or liabilities for similar items in active markets or supported by market data – for example, interest rates, credit spreads or yield curves. Adjustments may be needed to level 2 inputs, and if these are significant, the fair value may need to be classified as level 3.

**Level 3** inputs are unobservable inputs, which should be used as a minimum. Where situations occur when relevant inputs are not observable, they must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability.

The entity should maximise the use of relevant observable inputs and minimise the use of unobservable ones. The general principle of using an exit price remains and IFRS 13 does not preclude an entity from using its own data. For example, cash flow forecasts may be used to value an entity that is not listed. Each fair value measurement is categorised on the basis of the lowest level input that is significant to it.

## VALUATION CONCEPTS

IFRS 13 also sets out certain valuation concepts to assist in the determination of fair value. For non-financial assets only, fair value is decided based on the highest and best use of the asset as determined by a market participant.

The fair value of a liability or the entity's own equity assumes it is transferred to a market participant on the measurement date. Often there is no observable market to provide pricing information and the highest and best use is not applicable.

The fair value is then based on the perspective of a market participant who holds the identical instrument as an asset. If there is no corresponding asset, a valuation technique is used, as is the case with a decommissioning activity.

The fair value of a liability reflects the non-performance risk based on the entity's own credit standing plus any compensation for risk and profit margin a market participant might require to undertake the activity. Transaction price is not always the best indicator of fair value at recognition because entry and exit prices are conceptually different.

## DISCLOSURE

The guidance includes enhanced disclosure requirements that could result in more work for reporting entities. Required disclosures include:

- information about the hierarchy level into which fair value measurements fall;
- transfers between levels 1 and 2;
- methods and inputs to the fair value measurements and changes in valuation techniques; and
- additional disclosures for level 3 measurements that include a reconciliation of opening and closing balances, and quantitative information about unobservable inputs and assumptions used.

This article is merely a snapshot of a standard that will require a significant amount of work by entities simply to understand the nature of the principles and concepts involved.

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