

Fair value measurement guidance converges

What you need to know

- ▶ Common requirements now exist between US GAAP and IFRS on **how** to measure fair value
- ▶ IFRS 13 does not change **when** an entity is required to use fair value, but rather, provides guidance on **how** to measure the fair value of financial and non-financial assets and liabilities when required or permitted by IFRS
- ▶ While many of concepts in IFRS 13 are consistent with current practice, certain principles, such as the prohibition on blockage discounts for all fair value measurements, could have a significant effect on some entities
- ▶ The disclosure requirements are substantial and could present challenges for many entities
- ▶ IFRS 13 is effective 1 January 2013 and will be adopted prospectively
- ▶ For more information on the changes to US GAAP, see our 'To the Point' article *Fair value measurement guidance converges* at www.ey.com/us/accountinglink.

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) created a uniform framework for how to measure fair value for entities around the world.

By publishing IFRS 13 *Fair Value Measurement*, the IASB established a single source of guidance under IFRS for all fair value measurements. IFRS 13 does not change **when** an entity is required to use fair value, but rather, provides guidance on **how** to measure fair value under IFRS when fair value is required or permitted by IFRS.

Reasons for issuing IFRS 13

The IASB has issued IFRS 13 for a number of reasons; the main reason being to reduce complexity and improve consistency in application when measuring fair value. Many IFRS require or permit entities to measure or disclose the fair value of assets, liabilities, or equity instruments, but prior to the issuance of IFRS 13, the guidance on how to measure fair value was limited and, in some cases, the guidance was conflicting. IFRS 13 consolidates and clarifies the guidance on how to measure fair value.

Another reason that the IASB issued IFRS 13 was to enhance disclosures for fair value. The IASB believes the new disclosures will help users to better assess the valuation techniques and inputs used to measure fair value. As such, the issuance of IFRS 13 forms part of the IASB's response to the G20's requests in the wake of the financial crisis.

A third reason for issuing IFRS 13 was to increase convergence with US GAAP, which has also been amended by the FASB. The IASB and the FASB worked together to ensure that 'fair value' has the same meaning in IFRS and in US GAAP and that their respective fair value measurement and disclosure requirements are the same.

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)

Definition of fair value

“Fair value” is a phrase that is commonly used in practice, and often means different things to different people. The IASB defines “fair value” in the context of IFRS 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 (i.e., an exit price).

Fair value is not an entity-specific measurement, but rather is focused on market participant assumptions for a particular asset or liability. Therefore, when measuring fair value, an entity considers the characteristics of the asset or liability, if market participants would consider those characteristics when pricing the asset or liability at the measurement date. For example, such characteristics may include the following:

- ▶ The condition and location of an asset
- ▶ Restrictions, if any, on the sale or use of an asset (that would transfer with the asset)

How we see it

The language used to describe fair value may have changed, but in many cases, the principles for determining fair value remain unchanged. The effects of applying IFRS 13 are likely to vary by entity, and for some entities, the effects could be significant.

For example, if an entity previously did not consider the highest and best use of an asset when determining the fair value when revaluing its property, plant and equipment, adopting IFRS 13 could result in a higher fair value than it would have previously determined.

Identifying the principal market

A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the:

- ▶ *Principal market* – the market with the greatest volume and level of activity for the asset or liability

Or

- ▶ *Most advantageous market* (in the absence of a principal market) – 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.

How we see it

In general, the market in which the entity transacts most frequently is also the market with the greatest volume and deepest liquidity. In these instances, the principal market would likely be the same as the most advantageous market. However, when this is not the case, applying IFRS 13 could change current practice.

For example, if an entity previously measured the fair value of agricultural produce based on its local market, but there is a deeper and more liquid another market for the same agricultural produce (for which transportation costs are not prohibitive), the latter market would be deemed the principal market and would be used to determine fair value.

Characteristics of market participants

When determining fair value, management uses the assumptions that market participants would use when pricing the asset or liability. However, an entity need not identify specific market participants. Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

- ▶ Independent of each other, that is, they are not related parties
- ▶ Knowledgeable, having a reasonable understanding about the asset or liability using all available information, including information obtained through usual and customary due diligence
- ▶ Able to enter into a transaction for the asset or liability
- ▶ Willing to enter into a transaction for the asset or liability (i.e., they are not forced or compelled)

Fair value hierarchy

When measuring fair value, an entity is required to maximise the use of relevant observable inputs and minimise the use of unobservable inputs. IFRS 13 includes a fair value hierarchy (described in the table below) which prioritises the inputs in a fair value measurement.

Fair value hierarchy

	Level 1	Level 2	Level 3
Definition	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date	Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly	Unobservable inputs for the asset or liability
Example	Quoted prices for an equity security that trades on the London Stock Exchange	Interest rates and yield curves observable at commonly quoted intervals, implied volatilities and credit spreads	Projected cash flows used to value a business or non-controlling interest in an entity that is not publicly listed

The best indication of fair value is a quoted price in an active market. An active market is 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.

Valuation techniques and inputs

IFRS 13 describes three different valuation techniques that may be used to measure fair value (which would be classified within the hierarchy above based on the inputs used in the valuation technique):

- ▶ *Market approach*: uses prices and other relevant information from market transactions involving identical or similar assets or liabilities
- ▶ *Income approach*: converts future amounts (e.g., cash flows or income and expenses) to a single current (discounted) amount
- ▶ *Cost approach*: reflects the amount required currently to replace the service capacity of an asset (frequently referred to as current replacement cost, which differs from the cost incurred)

Management must use valuation techniques that are appropriate in the circumstances and for which sufficient data is available. In some cases, this will result in more than one technique being used (for example, using both an income and a market approach to value a business

or cash-generating unit). Regardless of the technique(s) used, entities are required to maximise the use of observable inputs and minimise the use of unobservable inputs. When multiple valuation techniques are appropriate, management evaluates the results and selects the point within any indicated range that is most representative of fair value in the circumstances.

Other measurement topics in IFRS 13

IFRS 13 also describes the following concepts, which may have an impact on how some entities determine fair value:

- ▶ For non-financial assets, management must consider the highest and best use of the asset by market participants
- ▶ For liabilities, a fair value measurement reflects non-performance risk, which is assumed to be the same before and after the transfer of a liability
- ▶ The fair value of a liability and an entity's own equity instruments are measured from the perspective of a market participant holding the identical instrument as an asset
- ▶ Premiums and discounts are permitted (other than blockage factors) if market participants would consider them in a transaction for the asset or liability (but only if the premium or discount is consistent with the unit of account in the IFRS that requires or permits the fair value measurement)
- ▶ When an entity manages a group of financial assets and financial liabilities based on its net exposure to market risks or credit risks, an entity is permitted to measure the fair value of that group based on the sale or transfer of its net position, but only if certain criteria are met
- ▶ Transaction price is often, but not always, the best indicator of fair value at initial recognition, because entry and exit prices are conceptually different
- ▶ When there is a significant decline in the volume and level of activity in a market, further analysis of the transactions is needed to assess their relevance

These concepts will be described in more detail in a future publication.

Expanded disclosure requirements

In response to the financial crisis, the IASB expanded the required disclosures related to fair value measurements to help users understand the valuation techniques and inputs used to develop fair value measurements and the effect of fair value measurements on profit or loss.

The IASB decided not to require a quantitative sensitivity analysis for non-financial assets and liabilities (as previously proposed) at this time. While the proposed disclosures were favoured by users and are consistent with the recommendations of the IASB's Expert Advisory Panel, the proposals were heavily criticised by preparers, who were concerned about the additional cost, among other concerns.

Instead, the IASB deferred adding this requirement until additional outreach could be completed. However, in the interim, the sensitivity disclosures that were previously required for financial assets and liabilities under IFRS 7 *Financial Instruments: Disclosures* continue to be required until this project is completed. In addition, for recurring fair value measurements within Level 3 of the hierarchy, an entity is required to disclose:

- ▶ Quantitative information about the significant unobservable inputs in the fair value measurement
- ▶ Qualitative information about the sensitivity of recurring Level 3 fair value measurements to changes in unobservable inputs disclosed, including a description of interrelationships between unobservable inputs

How we see it

We support the Boards' decision to postpone adding the disclosure of the effect of using other reasonable unobservable inputs on non-financial Level 3 measurements until additional field work is conducted.

Nevertheless, it may be challenging to comply with the new disclosure requirements. Capturing and disclosing information at a level that is meaningful to users of the financial statements, but still practical, will require judgement and may be difficult.

Remaining differences between US GAAP and IFRS

While much of the guidance has been converged, differences remain between IFRS and US GAAP, including:

- ▶ US GAAP does not require a quantitative sensitivity analysis for Level 3 financial instruments
- ▶ US GAAP includes a practical expedient for measuring certain alternative investments (e.g., investments in hedge funds, private equity funds, real estate funds) in an 'investment company' (as defined in current US GAAP) without a readily determinable fair value
- ▶ US GAAP does not restrict the recognition of day one gains and losses when fair value is determined using unobservable inputs

Effective date and transition

IFRS 13 is applied prospectively for annual periods beginning on or after 1 January 2013. Early application is permitted.

The new disclosures are only required for periods beginning after IFRS 13 is adopted – that is, comparative disclosures for prior periods are not required.

Next steps

Management should begin to assess the effect of adopting IFRS 13 on valuation policies and procedures. In addition, management should analyse the resources that will be needed to meet the new disclosure requirements.

A future publication will discuss the application issues of IFRS 13 in more detail.

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