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Exposure draft proposes expanded guidance on fair value measurement

Background

On 28 May 2009, the International Accounting Standards Board (IASB) issued an exposure draft (ED) ED/2009/5 *Fair Value Measurement*. The Board's intention is to replace all of the existing guidance on fair value measurement in IFRS accounting literature with a single Standard – equivalent to the US standard, FAS 157 *Fair Value Measurements*. The ED defines fair value, and it explains how to determine fair value; however, it does not introduce any new or revised requirements regarding which items should be measured or disclosed at fair value.

The final comprehensive Standard on fair value measurement is expected to be issued in the first half of 2010.

Summary of proposals

The ED defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly [i.e. not forced] transaction between market participants at the measurement date". The proposed Standard would apply to all fair value measurements or disclosures in all IFRSs, with one exception (the requirements of IAS 39.49 relating to the fair value of financial liabilities with a demand feature). Therefore, both financial instruments and non-financial items would fall within its scope.

The ED sets out the following elements to be determined by an entity in order to arrive at an appropriate measure of fair value:

- the particular asset or liability that is the subject of the measurement (consistently with its unit of account);
- for an asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use);
- the most advantageous market for the asset or liability; and
- the valuation technique(s) appropriate for the measurement – taking into consideration the availability of data with which to develop inputs that represent the assumptions that market participants would use in pricing the asset or liability, and the level of the fair value hierarchy within which the inputs are categorised.

The market participant in the most advantageous market

Central to fair value measurement is the price that would be achieved if the asset were sold (or the liability transferred) to a market participant in the most advantageous market to which the reporting entity has access. The most advantageous market is the market that maximises the amount that would be received on sale of the asset (or minimises the amount that would be paid to transfer the liability), taking account of transaction and transport costs, from the perspective of the reporting entity. However, transaction costs do not form part of the fair value measurement because they are not a characteristic of the asset or liability. If location is a characteristic of the asset (as might be the case for a commodity), the price in the most advantageous market is adjusted for the costs, if any, that would be incurred to transport the asset to or from that market. The market in which the entity normally transacts would be presumed to be the most advantageous market.

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The determination of the price that a market participant in the entity's most advantageous market would pay for an asset (or would accept for taking on a liability) will require judgement. For this purpose, the 'market participant' should be assumed (i) not to be a related party, (ii) to be knowledgeable, and (iii) to be willing and able to enter into a transaction for the asset or liability. Under the proposals, entities would not be required to perform a detailed search to specifically identify what each market participant would be willing to pay for the asset (or to accept to take on the liability).

There may be no actual transaction in the asset or liability at the measurement date (e.g. when fair value is being determined at the end of the reporting period for the purposes of subsequent measurement of an asset or liability). The absence of an actual transaction does not change the objective of fair value. A fair value measurement assumes a hypothetical transaction at the relevant date, using assumptions that market participants would use in pricing the asset or liability. When transactions are directly observable in a market, the determination of fair value is relatively straight forward. When they are not, a valuation technique is used.

Asset-specific valuations

When considering the price that a market participant would pay for an asset, the entity would be required to consider the market participant's ability to generate economic benefit 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' reflects the use of an asset that maximises the value of the asset (or the group of assets and liabilities within which the asset would be used), considering uses of the asset that are (i) physically possible, (ii) legally permissible, and (iii) financially feasible at the measurement date.

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. 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.

Liability-specific valuations

A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (i.e. the liability continues and the market participant transferee would be required to fulfil it); it is not settled with the counterparty to the liability. Where there is no observable market price for the transfer of a liability, an entity would be required to measure the fair value of a liability using the same methodology that the counterparty would use to measure the fair value of the corresponding asset (as the counterparty will fair value its asset based on transferring it, rather than demanding settlement from the obligor). An entity would need to adjust the observed price of the counterparty's asset for features that are present in the asset but not present in the liability, or vice versa.

When fair valuing a liability, non-performance risk (i.e. the risk that the entity will not fulfil an obligation) must be considered. Non-performance risk includes the entity's own credit risk.

Valuation techniques

The ED sets out three approaches for determining fair value using a valuation technique:

- a market approach – which uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (or businesses);
- an income approach – which converts future amounts (e.g. cash flows or income and expenses) to a single discounted present value amount; or
- a cost approach – which reflects the amount that would currently be required to replace the service capacity of an asset (often referred to as 'current replacement cost').

An appropriate valuation technique (i) will be consistently applied, (ii) will maximise the use of relevant observable inputs (and minimise unobservable inputs), and (iii) will be calibrated periodically to actual transactions.

Disclosures

Many of the disclosures for financial instruments proposed in the ED are already required under IFRS 7 *Financial Instruments: Disclosures* (as amended in March 2009). However, many of the proposed disclosures would be new to non-financial items within the scope of the ED.

Fair value measurement disclosures are based on a three-level fair value hierarchy based on inputs to the fair valuation. Level 1 inputs are directly and fully observable, Level 2 inputs are indirectly based on observable inputs, and Level 3 inputs are unobservable. An asset or liability is included in its entirety in one of the three levels based on the lowest level input that is significant to its valuation.

The ED proposes the following minimum disclosures for each class of assets or liabilities measured at fair value:

- the fair value measurement at the end of the reporting period;
- the level in the fair value hierarchy;
- transfers between Level 1 and Level 2 for those assets and liabilities recognised at the end of the reporting period;

- the methods and inputs used in the fair value measurement, including any changes in valuation techniques;

- a reconciliation of the opening and closing fair value of Level 3 assets and liabilities, including total gains and losses in the period, purchases, sales, settlements and transfers into or out of Level 3. In addition, separate disclosure would be required of the gains and losses in profit or loss for Level 3 assets and liabilities held at the end of the reporting period; and

- the sensitivity of Level 3 fair valuations to changes in inputs to a reasonably possible alternative assumption.

Where assets and liabilities are not subsequently measured at fair value, but are instead just disclosed at fair value, fair value should be disclosed by the level of the fair value hierarchy for each class of assets and liabilities.

The ED also includes the specific disclosures contained in IFRS 7 regarding the fair value of non-performance risk when subsequently fair valuing a liability.

Finally, where an asset is used together with other assets, and its highest and best use differs from its current use, the ED requires disclosure by class of asset of the fair value of the assets assuming their current use (i.e. the amount that would be their fair value if the current use were the highest and best use), the amount by which the fair value of the assets differs from their value in their current use (i.e. the incremental value of the asset group), and the reasons why the assets are being used in a manner that differs from their highest and best use.

Effective date and transition

The effective date of the new requirements will be determined when the final Standard is issued. The ED proposes prospective application as of the beginning of the annual period in which the final Standard is first applied, with an exemption from providing comparative information in the first period of application.

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