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IFRS Project Insights

Fair Value Measurement

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The IASB's objectives in the fair value measurement project are to establish a single source of guidance for all fair value measurements, to clarify the definition of fair value, to enhance disclosures about fair value and to increase convergence with US GAAP. The project addresses how to measure fair value but not when to measure it.

The Board issued ED/2009/05 *Fair Value Measurement* in May 2009 and has completed redeliberating the proposals in the ED. In June 2010, the Board re-exposed a portion of the disclosure requirements within ED/2009/05 by issuing ED/2010/07 *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements.* On 19 August 2010 the IASB posted to its website a staff draft of a forthcoming IFRS on fair value measurement that reflects the cumulative tentative decisions made to date by the IASB and the FASB as well as accompanying illustrative examples.

A comprehensive project summary was also published by the Board which provides background information of the fair value measurement project including a summary of decisions reached to date.

Tentative Decisions Reached during Redeliberations

Definition

Fair value is defined as an exit price resulting from an orderly transaction between market participants at the measurement date.

Exit price is an estimate of the price to sell an asset or to transfer a liability. It is not the price to buy the asset or to incur the liability. Furthermore, a fair value measurement is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement uses the assumptions market participants would use when pricing the asset or liability, including assumptions about risk.

Measurement guidance

The transaction to sell an asset or to transfer a liability occurs at the measurement date considering the market conditions at that date and the assumptions that market participants would use in pricing the asset or liability.

The reference market for a fair value measurement is the principal (or most advantageous) market to which the entity has access. A fair value measurement of a non-financial asset considers its highest and best use by market participants.

The transaction price might not represent the fair value of an asset or liability at initial recognition in all cases (e.g. transactions between related parties, forced sale transactions, a different unit of account or different market).

There may be no observable market transactions or market information might not be available. The exit price for an asset in a market that is not active is the price at which an orderly transaction between market participants would take place at the measurement date. An entity may need to use unobservable inputs which may include an entity's own data. However, an entity cannot ignore information about market participant assumptions that is reasonably available.

When markets are not active or are no longer active, measuring fair value depends on the facts and circumstances and requires the use of significant judgement. An entity will have to determine whether transactions in that market are not orderly. An entity would place little, if any weight on a transaction price in a transaction that is not orderly when measuring fair value or estimating market risk premiums.

The objective of a fair value measurement is to determine the price for a sale of an individual asset rather than as part of a group. When the highest and best use of a non-financial asset is to be used as part of a group of assets, however, the fair value measurement presumes a sale to a market participant that has, or can obtain, the ‘complementary assets’ and ‘complementary liabilities’.

The fair value of a liability includes the effects of non-performance risk. Non-performance risk includes the reporting entity’s own credit risk. However, the IASB recently issued amendments to IFRS 9 which provides that for financial liabilities where the fair value option has been selected, changes in fair value associated with an entity’s own credit risk would be recognized in other comprehensive income rather than profit or loss, unless doing so creates or exacerbates an accounting mismatch.

The unit of account for a financial liability may differ from the unit of account for that instrument held as an asset when a purchased and inseparable third-party credit guarantee is attached to the liability to create the asset. The existence of the third-party credit guarantee would also be separately disclosed by the issuer of the liability.

Additional guidance

In measuring fair value, an entity would not consider discounts and premiums when they are inconsistent with the unit of account specified in other standards. Additionally, the final Standard will not explicitly describe or distinguish between any premiums or discounts that might be applied in a fair value measurement and will not address the recognition of gains or losses when a transaction price differs from fair value because of the existence of a blockage factor. The final Standard will include guidance that a level 1 price quote should be used if available, and if not, an entity would determine if there is clear unit of account guidance. If unit of account guidance exists, an entity determines what premiums or discounts a market participant would use in valuing that unit of account. If guidance on unit of account does not exist, an entity would use a value maximization principle (i.e., a concept that market participants would enter into transactions which maximise the fair value of financial instruments).

In the absence of a quoted price for the identical liability in an active market, the fair value of the liability may be determined from the holder’s rather than issuer’s perspective (i.e. as an asset). Similarly, although equity instruments have different characteristics than liability instruments, an entity could utilise a holder perspective to determine the fair value of one’s own equity.

Usage of mid-market prices as a basis for establishing fair value for offsetting market risk positions (e.g. interest rate risk, currency risk or other price risk) and to applying the price within the bid-ask spread that is most representative of fair value to the net open risk position would be permitted under specified circumstances. Entities are also permitted to consider offsetting counterparty credit risk positions when measuring the fair value of financial instruments when there is a legally enforceable right of offset (e.g. a master netting agreement) in the event of default.

Permit an exception to the fair value measurement principles to allow for the measurement of the net exposure of a group of financial instruments measured at fair value when those instruments are managed on the basis of an entity’s net exposure to a particular market risk or to the credit risk of a particular counterparty. Entities would be required to make an accounting policy election in order to apply the exception. The final Standard will clarify that applying the exception should reflect arrangements that mitigate credit risk exposure when such arrangements are legally enforceable and the calculation of the credit adjustment should take into account the life of the potential exposure to credit risk. Entities may be required to allocate the net fair value amount back to the gross items for presentation purposes when offsetting is not achieved; however the final Standard will not prescribe a specific allocation approach.

Disclosures

The Standard would require among other disclosures:

- fair value information by level in the fair value hierarchy even for items that were not measured at fair value in the statement of financial position (but for which the disclosure of fair value is required in the notes);for Level 3 fair value measurements, a description of the valuation techniques and inputs used;

- when an asset is either subsequently measured at fair value in the statement of financial position or fair value of the asset is disclosed in the notes to the financial statements, and an entity uses that asset in a manner other than its highest and best use, a disclosure of that fact and the reason why;
- transfers of all items between Level 1 and Level 2 of the fair value hierarchy (in addition to transfers in and out of Level 3); and
- when fair value for an asset or liability is disclosed in the notes to the financial statements (but the asset or liability is not measured at fair value in the statement of financial position), the associated level within the fair value hierarchy should also be disclosed.

The final Standard will clarify that the disclosures apply to all fair value measurements, even those modified as part of the measurement attribute (e.g., recognised at fair value less cost to sell). Specifically for impaired assets measured fair value less costs to sell, the Board tentatively agreed to require disclosure of:

- the amount of the fair value measurement,
- the level within the fair value hierarchy;
- if applicable, any change in the valuation technique utilised and the reasons for that change, and
- quantitative information about significant inputs used in the fair value measurement.

The proposed measurement uncertainty analysis, including the effects of correlations between valuation inputs for all assets and liabilities for which a 'Level 3' fair value measure was required on a recurring basis (for IFRSs, this would include biological assets and investment properties and commodities measured at fair value to the extent they are classified as a Level 3 measurements), will be separated into a component project pending further research to better understand preparer concerns.

The Board tentatively agreed to exclude plan assets measured at fair value in IAS 19 from the scope of the fair value disclosure requirements and address disclosures about their fair value in IAS 19.

Effective date

The IASB tentatively decided that the final IFRS should be effective on 1 January 2013 with early application permitted.

Thinking ahead

- The final Standard will not change the extent to which transactions and arrangements are measured at fair value under IFRSs.
- The greatest similarity between the proposed standard and existing fair value measurement requirements is with respect to fair value measurement of financial instruments.
- The final Standard would not change the requirements in IAS 39 with respect to Day 1 gains and losses. However, the Board has agreed to revisit this issue at a later date, separate from the fair value measurement project.
- There may be a greater requirement for entities to consider in more detail what a market participant would pay for an asset, or be paid to take on a liability, in a theoretical transaction at the reporting date. Also, for non-financial assets, an analysis will be required as what is an asset's highest and best use, including an analysis of alternative users for the asset that are different to the entity's current use.

Next steps

The Board intends to issue a final Standard in April 2011.

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