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Financial INSIGHT

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IFRS 13 *Fair Value Measurement*

1. Background

On 13 May 2011, the International Accounting Standards Board ("IASB") issued IFRS 13 *Fair Value Measurement* ("IFRS 13"). The purpose of IFRS 13 is to replace the fair value measurement guidance contained in individual IFRSs with a single, unified definition of fair value.

IFRS 13 defines fair value and explains how fair value is determined; however, it does not introduce any new requirements as to which items should be measured or disclosed at fair value.

To increase consistency and comparability in fair value measurements and related disclosures, IFRS 13 establishes disclosures for fair value measurements using a three-level fair value hierarchy to reflect the availability of observable market inputs when estimating fair values. The hierarchy is as follows:

- **Level 1** - fair values measured using quoted prices (unadjusted) in active markets for *identical* instruments that the entity can access at measurement date;
- **Level 2** - fair value measured using quoted prices in active markets for *similar* instruments or using other valuation techniques for which all significant inputs are based on observable market data (inputs other than quoted prices included within Level 1); and
- **Level 3** - fair values measured using valuation techniques for which any significant input is not based on observable market data (i.e. unobservable inputs).

In light of the AASB's policy of incorporating IFRSs into Australian Accounting Standards, the AASB is expected to publish AASB 13 Fair Value Measurement in the near future.

This Financial INSIGHT provides an overview of the clarified definition of fair value and the additional guidance on the required disclosures about fair value measurements.

2. Overview of IFRS 13 *Fair Value Measurement*

Objective

The main objectives of IFRS 13 are to:

- Reduce complexity and improve consistency in the application of fair value measurement principles by having a single set of requirements for all fair value measurements;
- Communicate the measurement objective more clearly by clarifying the definition of fair value;

- Improve transparency by enhancing disclosures about fair value measurements; and
- Increase the convergence of IFRSs and US GAAP.

Scope

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements except the following:

- Share-based payment transactions within the scope of IFRS 2 *Share-based Payment*;
- Leasing transactions within the scope of IAS 17 *Leases*;
- Measurements that have some similarities to fair value but are not fair value, such as net realisable value in IAS 2 *Inventories* or value in use in IAS 36 *Impairment of Assets*;
- Plan assets measured at fair value in accordance with IAS 19 *Employee Benefits*;
- Retirement benefit plan investments measured at fair value in accordance with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*; and
- Assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36.

3. Key concepts of IFRS 13 *Fair Value Measurement*

Defining fair value as an exit price

IFRS 13 defines fair value 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. the exit price). This definition of fair value as an exit price emphasises that fair value is a **market-based measurement, not an entity-specific measurement**; and takes into account the market conditions at the measurement date. The definition of fair value in IFRS 13 is the same as in US GAAP.

IFRS 13 sets out the following elements to be determined by an entity to determine an appropriate measure of fair value:

- The particular asset or liability being measured;
- For a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets or on a stand-alone basis;
- The market in which an orderly transaction would take place for the asset or liability; and
- The appropriate valuation technique(s) to use when measuring fair value.

When measuring fair value, an entity will need to take into account the characteristics of the asset or liability such as the condition and location of the asset and, if any, the restrictions on the sale or use of the asset.

Principal and most advantageous market

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

a) In the *principal market* for the asset or liability; and

b) In the absence of a principal market, in the *most advantageous market* for the asset or liability.

Note: The principal market is the market in which the entity would normally enter into a transaction to sell the asset or transfer the liability.

Measuring the fair value of a liability

IFRS 13 states that in the absence of a quoted price in an active market to transfer the identical liability, an entity would measure the fair value of the liability as follows:

- Using the quoted price in an *active market* for the identical item held by another party as an asset, if that price is available.
- If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical liability held by another party as an asset.
- If neither of those observable prices is available using another valuation technique (such as an income approach or market approach).

Measuring the fair value when markets become inactive

IFRS 13 acknowledges that when a market activity declines, an entity must use a valuation technique to measure fair value. IFRS 13 provides detailed guidance for the following situations:

- When there is observable market activity for an asset or a liability;
- When there is a decline in observable market activity for an asset or a liability; and
- When there is typically no observable market activity for an asset or a liability.

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions.

Disclosure requirements

There are specific disclosure requirements contained in IFRS 13. The disclosures relate to providing information about how the entity measure fair value, using the 3 level hierarchy approach currently required by IFRS 7, and explaining changes from period to period, particularly for fair value measurements obtained using valuation models.

These disclosures are aimed at increasing transparency and improving the quality of information provided to users of financial statements.

4. Effective date

The standard applies to annual reporting periods beginning on or after 1 January 2013, with early adoption permitted.

5. Actions

IFRS 13 is an important addition to IFRS 9 / AASB 9 *Financial Instruments* (which have been issued and come into effect from 1 January 2013) where fair value plays an even more critical role in accounting for financial instruments than under the current standard.

This will have the largest impact on entities who hold complex financial instruments, however all entities are potentially affected.

If you wish to discuss any of the issues raised in this publication contact your local RSM Bird Cameron advisor.