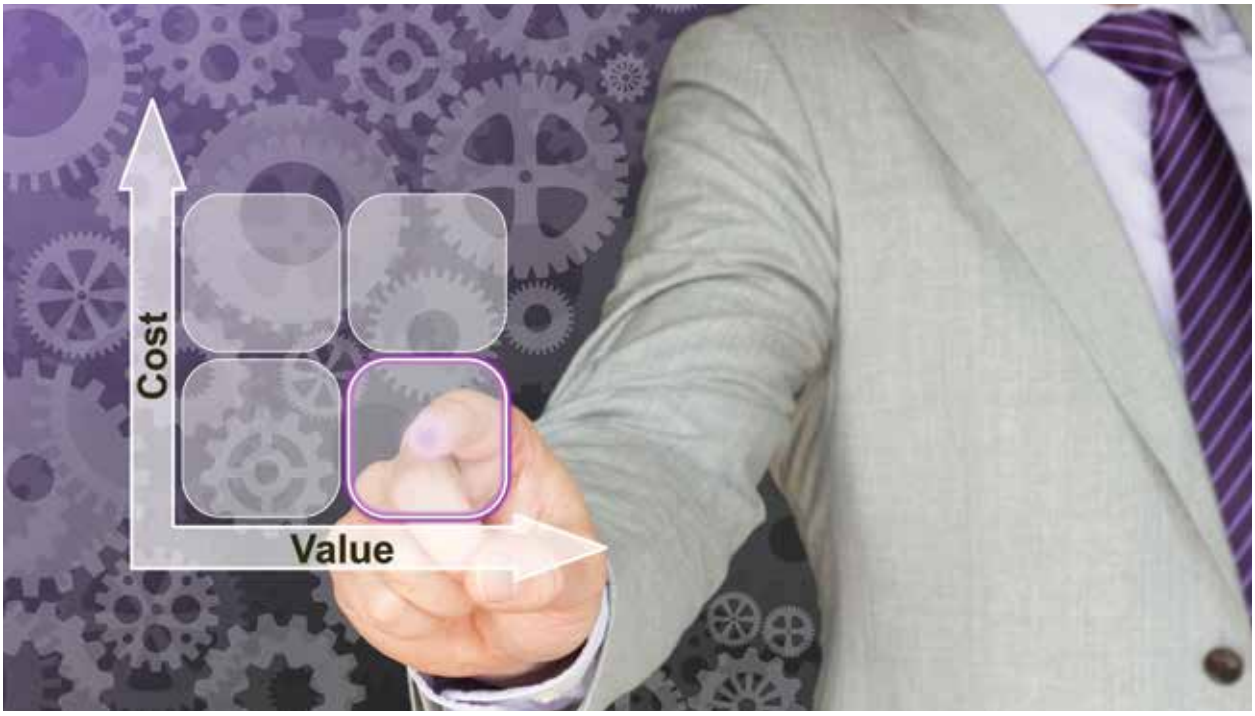
An Insight into IFRS 13: *Fair Value Measurement*



IFRS 13, Fair Value Measurement applies to IFRSs that require or permit fair value measurements or disclosures and provides a single IFRS framework for measuring fair value and requires disclosures about fair value measurement. It applies to both financial as well as non-financial items. The Standard defines fair value on the basis of an 'exit price' notion and uses a 'fair value hierarchy', which results in a market-based, rather than entity-specific, measurement. The Indian equivalent of IFRS 13 is Ind-AS 113: Fair Value Measurement. Read on to know more...

The Standard:

- Defines fair value
- To increase consistency of fair value measurement, provides a single set of requirements for measuring fair value and also illuminates how to measure fair value in different market situations
- Specify the fair value disclosure requirements to improve transparency.

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Applicability:

❖ It applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements. It applies to both financial as well as non-financial items.

❖ **Exemptions:**

A. From both measurement and disclosure requirements:
   - Share based payment transaction within the scope of IFRS2
   - Leasing transaction within the scope of IAS 17
   - Measurements that have some similarities to fair value, but are not fair value, such as:
     - o Net realisable value in IAS 2 Inventories

- o Value-in-use in IAS 36 Impairment of Assets.

B. From disclosure requirements only:
- Plan assets measured at fair value in accordance with IAS 19
- Retirement benefit plan investments measured at fair value in accordance with IAS 26
- Assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36.

Key Definitions:

- ***Fair Value:*** It 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. This is an exit price approach which emphasises on principal and most advantageous market along with market participants.
- ***Exit price:*** The price that would be received to sell an asset or paid to transfer a liability determined at measurement date under current market situations. This is regardless of whether that price is directly observable or estimated using any valuation technique.
- ***Principal Market:*** The market with highest volume of activity for a particular asset or liability.
- ***Most advantageous market:*** The market where one will receive highest amount on selling the asset or have to pay least amount to transfer the liability, after taking into account transaction costs and transport costs. In the absence of principal market, this should be referred.
- ***Market participants:*** These are independent buyers and sellers available in principal/most advantageous market who are well aware about the asset or liability and willing and able to enter into transaction.
- ***Transaction:*** It should take place between independent participants (not related party) and it should not be a forced transaction, involuntary liquidation or distress sale.

How it Applies To:

A. **Non-Financial assets:** IFRS states that fair value measurement of a non-financial asset must be based on the highest and best use of that asset considering:

i. Physical possibility: considering physical characteristics e.g. location, size.
ii. Legality: considering legal restrictions on use of particular assets (e.g. local regulations).
iii. Financial viability: considering adequate return on the investment made.

I. **Individual level:** If highest and best use is measured at an individual level then fair value is the price that would be received in a current sale, to a market participant, that would use the asset on an individual level.

II. **Combined level:** If highest and best use is measured at combined level then fair value is the price that would be received in a current sale, to a market participant, assuming the asset will be used in combination with those assets.

B. **Financial liabilities and Own equity instruments:** Ascertaining fair value of an entity's own equity or liability is a bit complex due to unavailability of quoted price for these transactions. In that condition, fair value should be measured from the perspective of a market participant who holds such item as an asset. When entity is measuring its liability then it is required to consider its own performance risk because, it would be considered by market participant who is holding that as an asset. It should be measured in the below manner at the measurement date:

i. Using the quoted price in an active market for the identical item; or
ii. Using other observable inputs; or
iii. Using other valuation techniques.

Application to Financial Assets and Financial Liabilities with Offsetting Positions

An entity that holds a group of financial assets and financial liabilities is exposed to:

- Market risk
- Counterparty credit risk

If an entity elects to manage group of financial assets or liabilities on the basis of its net exposure on market risk or credit risk, then it can opt to measure the fair value of that group on the net basis i.e.

- The price that would be received to sell a net long position or paid to transfer a net short position for particular risk exposure.

This is an **option** and an entity does not necessarily need to follow it. However, in order to apply this exception, an entity must fulfill all the following conditions:

› Manages the foresaid group on the basis of net exposure to market risk or the credit risk of a particular counterparty in accordance with the entity's documented risk management or investment strategy.

› Provides information on that basis about the offset group to the entity's key management personnel, as defined in IAS 24 Related Party Disclosures.

› And it's required (or has elected) to measure the offset group at fair value in the statement of financial position at the end of each reporting period.

Fair value at initial recognition: The transaction price is the price paid/received to acquire an asset or to assume a liability while fair value is the price that would be received to sell the asset or paid to transfer the liability. Generally, the transaction price is equal to the fair value – however, it is necessary to take into account factors specific to the transaction and to the asset or liability.

In the following situations, transaction price may differ from fair value and entities may need to use valuation techniques to determine fair value to be used as initial valuation

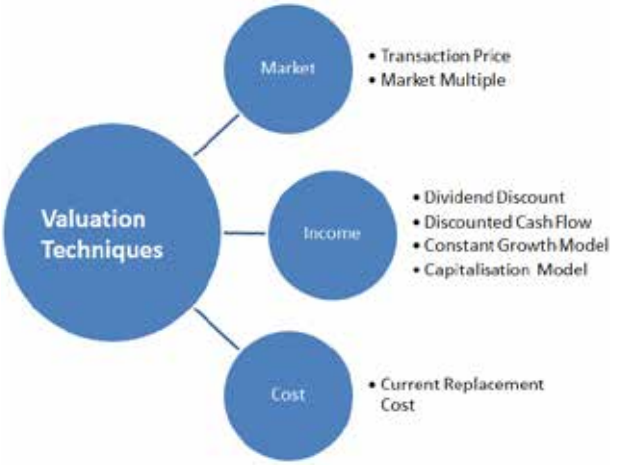
- Between related parties
- Entered under duress or forced circumstances
- In a market that is not the principal/most advantageous.

Valuation Techniques

As per **IFRS 13**, fair value is a market-based measurement, albeit it acknowledges that in some cases observable market transactions or other market information might not be available. The Standard neither contains a hierarchy of valuation techniques nor specifies the use of a specific valuation technique for fair valuation. However, before applying any valuation technique, below factors should be considered which can impact valuation.

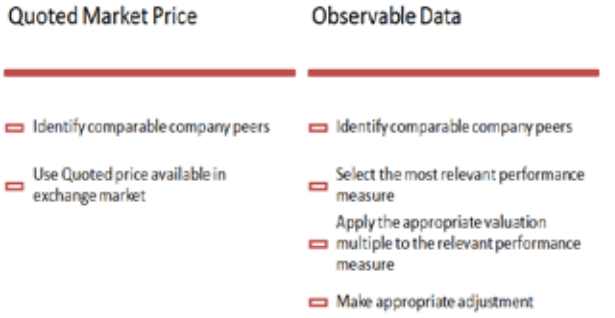
a. Sufficient availability of data to make any assumption regarding fair valuation
b. Maximising use of relevant observable inputs and reducing use of unobservable inputs
c. Investment prospect of market participant
d. Any other situation based or industry specific factors
e. Once used, it should be applied consistently.

Major valuation techniques:



A. **Market approach:** It uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or a group of assets and liabilities.

- o Transaction price: Reasonable starting point for measuring fair value of an unquoted equity instrument followed by below list of possible factors that can to be adjusted to corroborate the fair value as on measurement date:
  - Significant change in performance of the issuer since acquisition of asset
  - Significant change in global economy or the economic environment in which issuer operates
  - Performance of comparable entities
  - Internal affairs of investee, such as litigations, fraud, management strategy *etc.*
- o Market Multiple: It consist below steps for fair value measurement:



Step 1. Identification: Comparable companies which are similar to the investee in terms of business activities, markets served, size and geographical region and based on the assumption that entities in the same sector have similar risk, growth and cash flow profiles.

Step 2 & 3. Relevant Performance Measure and application of appropriate valuation multiple: Valuation basis can be:

a. Equity Value: Fair value of all equity claims which can also be termed as the enterprise value less the fair value of all non-equity financials claim on the entity.

b. Enterprise value: Fair value of all equity and non-equity financial claims attributable to all capital providers.

Performance basis can be categorised as:

- Earning Multiple: Commonly used when valuing an established business with an identifiable stream of continuing and stable earnings.
- Book Value Multiple: Commonly used by market participants in industries where entities use their equity capital bases to generate earnings.
- Revenue Multiple: for businesses that have not yet generated positive earnings, multiples of revenue might sometimes be used as a basis for valuation. In those cases, however, judgment needs to be exercised because there might be differences between the profitability of the investee and that of its comparables.

Step 4. Adjustments: Valuation multiple needs to be adjusted for differences from comparable peers such as:

- Operational:
  - Size (assets, revenue *etc.*)
  - Market and customer diversification
  - Capital structure
  - Economic environment (developed or emerging)
- Normalisation:
  - Elimination of exceptional or non-recurring transaction
  - Adjustment for understatement or overstatement of any transaction
  - Impact of merger, de-merger or acquisitions
- Non-operating items
  - Adjustment for non-operating items from total asset size.

B. **Income Approach:** Future cash flows are converted into a single current (i.e. discounted) amount. FV measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

Some of the key techniques are:

- Dividend discount model
- Discounted cash flow method
- Constant growth model
- Capitalisation model

C. **Cost Approach:** It reflects the amount that would be required to replace the service capacity of an asset (referred as current replacement cost).

The primary method used to calculate fair value under cost approach is depreciated replacement cost method. It considers how much it would cost to reproduce an asset of equivalent utility taking into account physical, functional and economic obsolescence. It estimates the replacement cost of the required rather than the actual asset.

It is normally used when there is either no evidence of transaction prices for similar property or no identifiable actual or notional income stream that would accrue to the owner of the relevant interest. This approach is seldom used to establish the fair value of investment property and applies more to fair valuing owner occupied property.

Fair Value Hierarchy: IFRS 13 introduces a fair value hierarchy that categorises valuation techniques inputs into 3 levels. Basic goal is to increase consistency and comparability in FV measurements. The three level hierarchy is as follows:

- **Level 1:** Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date and it provides the most reliable evidence of FV.

  In some cases, Level 1 input will be available from multiple active markets, and therefore, the emphasis should be:
  - It is derived from the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability; and
  - Whether the entity can enter into a transaction for the asset or liability at the

price in that market at the measurement date.

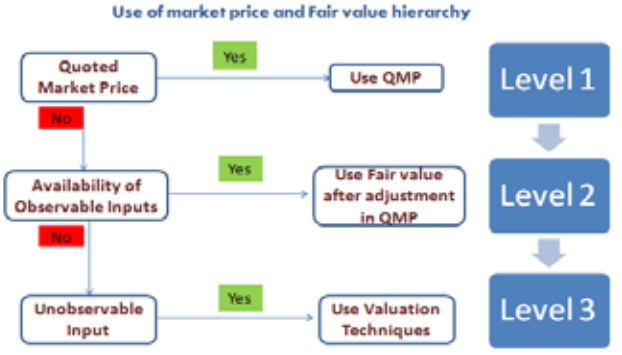
- **Level 2:** Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly and it must be observable for substantially the full term of the asset or liability. It includes:
  - Quoted prices for similar assets or liabilities in active markets.
  - Quoted prices for identical or similar assets or liabilities in markets that are not active.
  - Inputs other than quoted prices that are observable for the asset or liability e.g. interest rates, yield curves, credit spreads *etc.*

  Please note that an adjustment to a Level 2 input that is significant to the entire measurement might result in a FV measurement categorised within Level 3 of the hierarchy if the adjustment uses significant unobservable inputs.

  Received fix & pay variable interest rate swap, Licensing arrangement and Cash generating units are some example of level 2 hierarchy.

- **Level 3:** Unobservable inputs for the asset or liability. An entity shall use Level 3 inputs to measure fair value only when relevant observable inputs are not available. While using unobservable inputs it should be taken care that it shall reflect the appropriate assumptions that market participants would use to price an asset or liability, including assumptions about risk (risk inherent in a particular valuation technique).

  Long-dated currency swap, Complex structure Interest rate swaps and private equity are some examples of level 3 hierarchy.



Disclosures

The Standard requires extensive disclosure of sufficient information to assess:

a. The valuation techniques and inputs used to develop those measurements

b. For fair value measurements using significant unobservable inputs, the effect of the measurements on profit or loss or other comprehensive income for the period.

IFRS 13 requires specific disclosures based on whether fair value measurement is recurring (RFVM) or non-recurring (NRFVM). However, RFVM or NRFVM are not defined in IFRS 13. Below is a summarised list of disclosure requirements:

Disclosure requirement	RFVM	NRFVM
FV at reporting date	X	X
Reasons for FV measurement		X
FV hierarchy level i.e. Level 1, 2, or 3	X	X
Transfers between Level 1 and 2 (including reasons for the transfer and the entity's policy for transfer)	X	
Valuation technique, inputs, changes, reasons for change etc.- Level 2 and 3	X	X
Level 3 valuation processes/ policies	X	X
Level 3 unobservable inputs	X	X
Level 3 reconciliation of total gains or losses in P&L and OCI, purchases, sales issues, settlements, and transfers	X	
Level 3 unrealised gains /losses recognised in P&L	X	
Level 3 sensitivity to changes in unobservable inputs (Qualitative for non-financial instruments, quantitative for financial instruments)	X	
Reasons if Highest and Best Use differs from current use	X	

Disclosure Exemption:

- 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.
- Assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36 Impairment of Assets. ■

It is more fitting for a man to laugh at life than to lament over it. - Seneca