

# Fair value measurement – proposals for a new standard

## Background

Many IFRSs require or permit entities to measure assets, liabilities or equity instruments at fair value, while others require disclosure of fair value. However, limited guidance exists on how to measure fair value, and that which does exist is dispersed throughout many standards and is not always consistent. To address this, the International Accounting Standards Board (IASB) issued an Exposure Draft (ED) proposing to clarify the definition of fair value, establish a single framework for measuring fair value and enhance the disclosures when fair value is used. The guidance on fair value contained in other IFRSs will be removed. The ED however does not indicate where fair value is used, and, as such, does not propose to extend its use.

The IASB issued for comment a Discussion Paper (DP) on fair value measurement in November 2006. This DP requested feedback on the applicability of the US Standard SFAS 157 *Fair Value Measurement* for IFRS. This ED reflects the Boards' deliberations on the feedback received, and the experience of implementing SFAS 157 in the United States.

## Key proposals of ED 2009/05

### Definition of fair value

The ED proposes to define 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.'

That is, it is an exit price. While this core principle only discusses assets and liabilities, it is equally applicable to equity instruments.

Key aspects of the definition proposed in the ED are:

- ▶ **Characteristics of the asset/liability** - A fair value measure is performed for a particular asset or liability and, therefore, considers only the characteristics of the asset or liability that market participants would consider when determining a price at the measurement date. Conditions specific to the entity are not taken into account.
- ▶ **Orderly transactions** - Assumes exposure to the market for a period to undertake usual marketing activities. It is not a forced transaction. Additional guidance is given as to how to determine whether a transaction is forced, consistent with the recently issued guidance in the US.



A fair value measure reflects a market participant's ability to use the asset to its highest and best use.

- ▶ **Most advantageous market** - A fair value measure reflects a transaction taking place in the most advantageous market to which the entity has access. This is one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer a liability after considering transaction and transport costs.

This assessment is made from the perspective of the reporting entity, and is presumed to be the market that the entity would normally enter into such a transaction. The principal market (the market with the greatest volume and level of activity for the asset or liability) may be assumed to be the most advantageous market if this is accessible by the entity.

While transaction and transport costs are relevant to identify the market, they are not considered in determining the fair value.

- ▶ **Market participants** - Buyers and sellers in the most advantageous market that are:
  - ▶ Independent of each other
  - ▶ Knowledgeable about the asset or liability
  - ▶ Able to enter into a transaction
  - ▶ Willing to enter into a transaction, rather than being forced or otherwise compelled to.

A fair value measure uses the assumptions that market participants would take into account.

- ▶ **Highest and best use** - A fair value measure reflects a market participant's ability to use the asset to its highest and best use. This is the use that maximises the value of the asset, considering uses that are physically possible, legally permissible and financially feasible, and does not consider the intended use of the asset by the acquirer/holder.

- ▶ If the asset is used with other assets in a way that differs from its highest and best use, a value is determined based on the current use of all assets, and the difference is allocated to the asset that is being valued.
- ▶ An 'in-use' valuation premise is applied if the asset would provide maximum value to market participants principally through its use in combination with other assets and liabilities as a group. Under such a premise, the fair value is based on the price to sell the asset where a market participant will use the asset with other assets and liabilities.
- ▶ An 'in exchange' valuation premise is applied if the asset would provide maximum value to market participant principally on a stand-alone basis. Under such a premise, the fair value is based on the price to sell the asset where a market participant will use the asset on a stand-alone basis.

The ED notes that financial instruments will always have an 'in exchange' valuation premise. It also states that this must reflect any benefits that market participants would derive from holding that asset in a diversified portfolio.

- ▶ **Transfer of a liability** - a fair value measure reflects the continuation of the liability - that is, another market participant would fulfil the obligation, rather than it being settled with the counterparty or otherwise extinguished. The risk that an entity will not fulfil an obligation - referred to as non-performance risk - is taken into account. This risk is assumed to be the same before and after the transfer, and includes an entity's own credit risk.

If there is no observable market price for the transfer of the liability, fair value is determined by using the same methodology that the counterparty would use to measure the fair value of the corresponding asset.



- ▶ When the corresponding asset is a debt security, and that debt security is traded in an active market, the observed price in that market (adjusted for features that may be specific to the asset and not the liability or vice versa) also represents fair value of the issuer's liability.
- ▶ If there is no corresponding asset for a liability, present value or other valuation techniques are used to estimate the price that market participants would demand to assume the liability.

However, for a financial liability with a demand feature, the current requirements of IAS 39 *Financial Instruments: Recognition and Measurement* will continue to apply, such that fair value cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

- ▶ **Equity instruments** - fair value is measured from the perspective of a market participant who holds the instrument as an asset.

#### Valuation techniques

Where fair value is determined using a valuation technique, the ED proposes that the technique should be either a market approach, income approach or cost approach, as appropriate. It also includes

guidance about applying these various techniques.

The ED also proposes that:

- ▶ If an input is based on bid and ask prices, a price within the bid-ask spread that is most representative of fair value is used. Mid-market pricing or other conventions based on the bid-ask spread may be used to as a practical expedient for determining fair value.
- ▶ Blockage factors (an adjustment for the illiquidity of large holdings of financial instruments) are not included in a fair value measure.

Additional guidance is included in the ED addressing how to approach the determination of fair value when there is no active market. In particular, consistent with the guidance issued in the Expert Advisory Panel (EAP) document in 2008, the ED notes that actual transactions that occur in an inactive market cannot be ignored. However, if there is evidence that transactions were not orderly, the ED proposes that little, if any, weight should be given to them.

#### Fair value at initial recognition

The ED notes that, in many cases, the transaction price to acquire an asset or to assume a liability (entry price) will equal the exit price. The ED implies that an entity must assess if the transaction price would

represent its fair value, by considering the factors specific to the transaction and the asset or liability. While the ED does not give a principle for this assessment, it notes that transaction price is the best evidence of fair value at initial recognition unless:

- ▶ The transaction is between related parties.
- ▶ The transaction takes place under duress or is a forced transaction.
- ▶ The unit of account of the transaction differs from the asset for which fair value is being determined.
- ▶ The market in which the transaction takes place differs from the market in which the entity would normally sell the asset.

If the transaction price differs from its exit price, the ED proposes that the difference is recognised in the profit or loss unless an IFRS requires some other treatment. Currently, IAS 39 *Financial Instruments: Recognition and Measurement* requires day one profits to be deferred in some cases, and no changes have been proposed to this requirement.

#### Fair value hierarchy

The ED proposes a fair value hierarchy that prioritises the inputs used to measure fair value into three levels as summarised in table 1. This same hierarchy is used when approaching both the measurement of, and disclosure about, fair values.

**Table 1: Fair value hierarchy for measurement and disclosure of assets and liabilities**

Level 1 inputs	Level 2 inputs	Level 3 inputs
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 in level 1 that are directly or indirectly observable.	Inputs that are not based on observable market data. The assumptions used must reflect those that market participants would use, including risk.
An active market is defined as one in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. This is consistent with its respective definition in other IFRSs.	If the asset or liability is for a specified term, the input must be observable for substantially the full term.	

Additional guidance is included in the ED to determine whether or not a market is active, consistent with the recently issued guidance in the US.

### Disclosures

The ED proposes to incorporate the fair value disclosures adopted in the recent revisions to IFRS 7 *Financial Instruments: Disclosures* (see *Supplement to IFRS outlook Issue 3.1*), to extend these beyond financial instruments – to all assets, liabilities or equity that are measured at fair value. It also extends this, by requiring disclosure of the fair value hierarchy for assets or liabilities where fair value information is only disclosed, even though the items are not measured at fair value – for example financial instruments carried at amortised cost (this proposal was contained in the ED amending IFRS 7, but was ultimately not included in the final amendments.)

Additional disclosures are also proposed for liabilities measured at fair value after initial recognition, and when the highest and best use of an asset differs to its current use.

The ED also proposes amending IAS 34 *Interim Reporting* to require similar disclosures about the fair value of financial instruments in interim financial statements.

## Business impact

For financial instruments, the proposals in the ED are more or less consistent with the existing requirements of IAS 39 and IFRS 7 *Financial Instruments: Disclosures* and the guidance issued by the Expert Advisory Panel. However, the extension of the disclosure requirements to assets or liabilities for which fair value is only disclosed and non-financial items will potentially result in additional changes to information systems.

The requirement to determine fair value by reference to market participants is not new, however, the specific requirements relating the highest and best use, and the most advantageous markets may require companies to re-evaluate the processes and procedures for determining fair value in the future.

For entities that maintain portfolios of financial assets, the effects of the proposals are less clear. For example, it is not clear to what extent adjustments can be made to reflect credit risk assessed at a portfolio level, as is done in practice. Nor is it clear how the costs of closing out positions should be reflected, as they are in essence transaction costs, but are also an element of the bid-ask spread for a stand-alone instrument.

In addition, as the fair value premise relies on transactions that are not between related parties, determining the fair value for transactions that do occur between related parties may prove challenging, particularly when there are no observable market transactions or inputs.

Comments are due by 28 September 2009

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