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SLFRS 13 : Fair Value Measurement

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When is Fair Value Measurement Required?

Many accounting standards require or allow items to be measured at fair value

Recurring – at each reporting date

- Financial assets at FVTPL and FVOCI (SLFRS 9)
- Investment property (LKAS 40)
- PPE (LKAS 16)
- Intangible assets (LKAS 38)
- Defined benefit pension plan assets (LKAS 19)
- Biological assets (LKAS 41)

Non-recurring

- Business combinations (SLFRS 3)
- Non-current assets held for sale (SLFRS 5)
- Impairment of assets – fair value less costs to sell (LKAS 36)

Rationale for SLFRS 13

- Requirement to measure/disclose fair value in many standards

- Some inconsistency between standards

- Convergence of US GAAP and IFRS

Objective

Three principal objectives:

1) Define what fair value is, for use in all SLFRSs
2) To set out a single framework for measuring fair value, within a single SLFRS
3) To set out the disclosure requirements for fair value measurements, within a single SLFRS.

When does SLFRS 13 apply?

- When another SLFRS requires or permits fair value measurements or disclosures about fair value measurements

- SLFRS 13 also applies to measurements, such as fair value less cost to sell, based on fair value or disclosures about those measurements

When does SLFRS 13 apply?

Provide a single source of guidance for fair value measurement where it is required by a reporting standard, rather than it being spread throughout several reporting standards

Scope Exclusions

Measurement & disclosure exemptions

- Share based payments (SLFRS 2)
- Leasing transactions (SLFRS 16)
- Measurements similar to fair value but not the same:
  - Net realisable value in (LKAS 2)
  - Value in use in (LKAS 36).

Scope Exclusions

Disclosure exemptions only

- Plan assets at fair value (LKAS 19)
- Retirement benefit plan investments at fair value (LKAS 26)
- Fair value less costs to sell under LKAS 36

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Definition of Fair Value

- 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

- It is an exit price
  - The price that would be received to sell an asset or paid to transfer a liability

Definition of Fair Value

- Market participants are ‘buyers and sellers in the principal (or most advantageous) market for the asset or liability’ having all the characteristics below:
    - Independent
    - Knowledgeable
    - Able to transact
    - Willing to transact

- Fair value is a market-based measurement, not one that is entity specific.

Definition of Fair Value

- It should be assumed that market participants are not forced into transactions (i.e. they are not suffering any cash flow shortages)

- When pricing an asset or liability, Market participants consider the characteristics of the asset or liability
  - Condition
  - Location
  - Age and remaining economic life
  - Restrictions on use or sale

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Definition of Fair Value

- *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*

Measurement date could be:

- Reporting date
- Date of acquisition of asset or of business combination
- Date of transition to SLFRSs

Valuation Techniques

- SLFRS 13 notes that there are various broad categories of valuation techniques to determine the fair value of an asset or liability
  - Market approaches (valuations based on recent sales prices)
  - Income approaches (valuations based on forecasted cash flows)
  - Cost approaches (valuations based on replacement cost)

Valuation Techniques

- Technique is appropriate in the circumstances
- Sufficient data must be available
- Maximise use of relevant observable inputs
- Minimise use of unobservable inputs

Different levels of Inputs

- SLFRS 13 classifies inputs into valuation techniques into three levels.
  - **Level 1** inputs are quoted prices for identical assets in active markets
  - **Level 2** inputs are observable prices that are not level 1 inputs. This may include
    - Quoted prices for similar assets in active markets
    - Quoted prices for identical assets in less active markets
    - Observable inputs that are not prices
  - **Level 3** inputs are unobservable. This could include cash or profit forecast using entity’s own data

Different levels of Inputs

- A significant adjustment to a level 2 input would lead to it being categorized as a level 3 input
- Priority is given to level 1 inputs. The lowest priority is given to level 3 inputs

Different levels of Inputs - Example

	Asset	Example
Level 1	Equity shares in a listed entity	Unadjusted quoted prices in an active market.
Level 2	Building held and used	Price per square metre for the building from observable market data, such as observed transactions for similar buildings in similar locations.
Level 3	Cash-generating unit	Profit or cash flow forecast using own data.

Different levels of Inputs - Example

Sun Ltd has an investment property that is measured at fair value. This property is rented out on short-term leases.

The directors wish to fair value the property by estimating the present value of the net cash flows that the property will generate for Sun Ltd. They argue that this best reflects the way in which the building will generate economic benefits for Sun Ltd.

The building is unique, although there have been many sales of similar buildings in the local area.

Required:

Discuss whether the valuation technique suggested by the directors complies with SLFRS 13

Different levels of Inputs - Example

- The directors' estimate of the future net cash flows that the building will generate is a level 3 input. SLFRS 13 gives lowest priority to level 3 inputs. These should not be used if a level 1 or level 2 input exists.
- Observable data about the recent sales prices of similar properties is a level 2 input. The fair value of the building should therefore be based on these prices, with adjustments made as necessary to reflect the specific location and condition of Sun Ltd's building.

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Applying SLFRS 13

Which Asset?

- Stand-alone – PPE, financial asset
- Group of Assets – CGU, business

Which valuation technique?

- Market approach
- Income approach
- Cost approach

Which inputs should be used

- Observable inputs
- Unobservable inputs

Markets

Principal market

- Market with the greatest volume and level of activity

Most advantageous market

- Market that maximises the amount that would be received to sell the asset, or minimises the amount that would be paid to transfer the liability, after taking into account:
  - Transaction costs
  - Transport costs.

Note: The ***most advantageous market*** in only used in the absence of a ***principal market***.

Markets

Key considerations and presumptions

- Determine from the perspective of the reporting entity
- Access as at the reporting date
- Transaction costs are taken into account in establishing the *most advantageous market* **but not** in measuring fair value. This is because transaction cost is a characteristic of the transaction, rather than the asset
- Presumption that *principal market* is the one in which the entity normally transacts.

Markets - Example

What is the fair value,

- If market 1 is principal market for the asset
- If no principal market can be determined

	Market 1	Market 2
	Rs.	Rs.
Price	26	25
Transaction cost	-3	-1
Transport cost	-2	-2
Net price received	21	22

Bid – Ask Spread

- Price in the spread that is most representative of fair value in the circumstances

- ***Bid price*** for assets and ***Ask price*** for liabilities are permitted, but not required, by SLFRS 13

- SLFRS 13 does not preclude the use of:
  - Mid-market pricing
  - Other pricing conventions <u>that are used by market participants</u> as a practical expedient for fair value measurements within a bid-ask spread.

Non-financial Assets

- Non-financial assets include
  - Property, plant and equipment
  - Intangible assets
- SLFRS 13 says that the fair value of a non-financial asset should be based on its **highest and best use**
- The highest and best use of an asset is the use that a market participant would adopt in order to maximize its value

Non-financial Assets

- The current use of a non-financial asset can be assumed to be the highest and best use, unless evidence exists to the contrary

- The highest and best use should take into account uses that are:
  - Physically possible
  - Legally permissible
  - Financially feasible

Non-financial Assets - Example

Star has purchased 100% of the ordinary shares of Moon and is trying to determine the fair value of the net assets at the acquisition date.

Moon owns land that is currently developed for industrial use. The fair value of the land if used in a manufacturing operation is Rs.5 million.

Many nearby plots of land have been developed for residential use (as high-rise apartment buildings). The land owned by Moon does not have planning permission for residential use, although permission has been granted for similar plots of land. The fair value of Moon's land as a vacant site for residential development is Rs.6 million. However, transformation costs of Rs.0.3 million would need to be incurred to get the land into this condition.

Required:

How should the fair value of the land be determined?

Non-financial Assets - Example

Land is a non-financial asset. SLFRS 13 says that the fair value of a non-financial asset should be based on its highest and best use. This is presumed to be its current use, unless evidence exists to the contrary.

The current use of the asset would suggest a fair value of Rs.5 million.

However, there is evidence that market participants would be interested in developing the land for residential use.

Residential use of the land is not legally prohibited. Similar plots of land have been granted planning permission, so it is likely that this particular plot of land will also be granted planning permission.

If used for residential purposes, the fair value of the land would be Rs.5.7 million (Rs.6m – Rs.0.3m).

It would seem that the land's highest and best use is for residential development. Its fair value is therefore Rs.5.7 million.

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Disclosures

- Objective of disclosures for assets and liabilities measured at fair value is to provide information that enables financial statements users to assess
  - methods and-inputs used to develop those measurements
  - for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of measurements on profit or loss or OCI

Disclosures

- SLFRS 13 requires certain minimum disclosures by classes of assets and liabilities
- SLFRS 13 requires that an entity should present quantitative disclosures in a tabular format unless another format is more appropriate
- Quantitative disclosure about unobservable inputs for Level 3
- Description of Level 3 valuation processes, policies and procedures

Disclosures

- Narrative description of sensitivity to changes in unobservable inputs for recurring Level 3 measurements, including inter-relationships between inputs
- Fair value hierarchy and valuation techniques for amounts not measured at fair value but fair value is disclosed in the financial statements
- Accounting policy about the timing of recognising transfers between level of hierarchy

Disclosures - Example

Below is an extract from a disclosure note about the fair value of an entity's financial assets and liabilities:

Fair value of financial instruments

	Level 1	Level 2	Level 3
	Rs Mn	Rs Mn	Rs Mn
Financial asset – traded equities	110		
Financial liability – contingent consideration			33

The fair values of the traded equities have been determined by reference to market price quotations.

The fair value of contingent consideration is estimated based on the forecast future performance of the acquired business over a timeframe determined as part of the acquisition agreement, discounted as appropriate. Key assumptions include growth rates, expected selling volumes and prices and direct costs during the period.

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Disclosures - Example

This disclosure informs users that the fair value of investments in equities has been derived using level 1 inputs (quoted prices for identical assets in active markets). This measurement involves no judgement, eliminating the risk of bias, and can be verified by knowledgeable third parties.

In contrast, the disclosure informs users that the fair value of the contingent liability has been derived using level 3 inputs. This measurement involves a high level of judgement, increasing the risk of management bias. It also makes it more likely that the amount eventually paid by the entity will differ materially from the year-end carrying amount. For this reason, the disclosure provides additional information about how management have estimated the fair value of the liability, so that the users can assess the adequacy of the methodology used and reach a conclusion as to whether the level of measurement uncertainty is acceptable to them.

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Thank you.