THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

SLFRS 13 Fair Value Measurement Objectives

– Provide single source of guidance
– Clarify definition of fair value
– Provide clear framework for measuring fair value
– Enhance fair value disclosures
– Does not deal with when is fair value required
– Enhance convergence with US GAAP

When is Fair Value Measurement Required?

Recurring – at each reporting date

- Financial assets at FVTPL and AFS (LKAS 39/SLFRS 9)
- Investment property (LKAS 40)
- PPE (LKAS 16)
- Intangible assets (LKAS 38)
- Defined benefit pension plan assets (LKAS 19)
- Biological assets (LKAS 41)
- Investment entities (SLFRS 10)

Non-recurring

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

Scope

Scopes out :

- SLFRS 2 & LKAS 17 transactions
- Measurements similar to but that are not fair value (e.g. LKAS 36 VIU)

SLFRS 13 **disclosures** not required for:

– LKAS 19 plan assets at fair value
– LKAS 26 retirement benefit plan investments at fair value
– Fair value less costs to sell under LKAS 36

Applies to initial and subsequent measurement

Timing

- Mandatory for years commencing 1/1/2014
- Prospective application
- Comparatives not required for periods before adoption date
- Optional early adoption

Definition of fair value

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.

- Exit price concept
- Consider characteristics of asset/liability (i.e condition, location, restrictions on sale/use)
- Excludes transaction costs
- Includes transport costs
- Liability fair value reflects own non-performance risk
- Does not mandate bid price for assets and ask price for liabilities, Does not preclude mid-market or other pricing conventions

What must be done?

Determine:

– Asset/liability being measured

– Principal/ most advantageous market

– Non-financial assets:

  - What is highest and best use (HABU)
  - Whether HABU is on stand-alone basis or with other assets

– Quoted price / valuation technique to measure fair value

Identifying the market

- Use **principal market** if available

The market with the greatest volume and level of activity for the asset or liability.

- Otherwise, use **most advantageous market**

The 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 and transport costs.

Identifying the market

- Asset can be sold in 2 markets with same levels of activity.

	Market A	Market B
Price	26	25
Transport costs	-2	-2
	24	23
Transaction costs	-3	-1
	21	22

Fair value: £23

Most advantageous market: £22

What is the fair value?

Market participant perspective

- 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, i.e. not forced
- Use assumptions & characteristics that market participants consider (not necessary to identify specific participants)
- Market-based measurement, not entity-specific

Measurement date

'Fair value 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'

Measurement date could be:

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

Highest and best use (HABU)

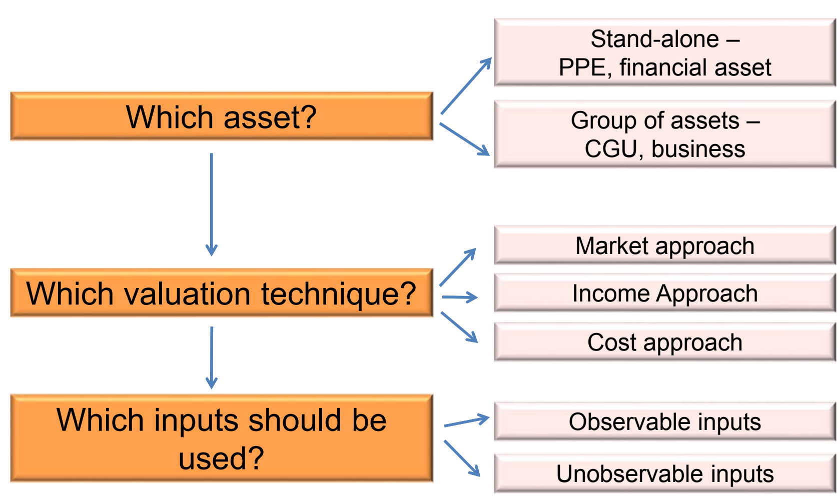
- – Non-financial asset fair values based on HABU
- – Does not apply to financial instruments or liabilities
- – HABU
  - stand-alone basis or combined with other assets and/or liabilities
  - based on market participants' perspective; intentions irrelevant
  - physically possible; legally permissible; financially feasible
  - usually, but not always, current use

Highest and best use (HABU)

- Land on which a factory is developed is acquired in a business combination.
- Fair value of the land is Rs10m when used as factory site.
- The land can be rezoned into residential use. Fair value is Rs11m when used as a residential site.
- The costs of demolishing the factory and rezoning is Rs 2m.

- What is the fair value of the land?
- Answer: Rs10m

Applying SLFRS 13 – Determination of Fair values



Valuation techniques

- Market, income or cost approach
- Assess appropriateness based on circumstances
- Maximise observable inputs

Change in technique acceptable if equally or more representative of fair value

Valuation Techniques

- **Market approach** – uses prices and other relevant information involving identical or similar assets or liabilities
- **Income approach** – converts future amounts (e.g. cash flows or income and expenses) to a single current (discounted) amount
  - ✓ DCF, Black Scholes, multi-period excess earnings
- **Cost approach** – reflects amount currently required to replace the service capacity of an asset
  - ✓ Current replacement cost

In some cases these approaches can be combined

- ✓ E.g. value a business using an income (forecast profits) and a market approach (applying a market multiple – price-earnings ratio)

The Market Approach

The *Market Approach* is based on:

1. The current price for the asset/liability; or
2. The price of a recent transaction in the asset/liability; or
3. Adjusting the prices in 1 and 2 for a similar asset/liability.

Examples for the use of *Market approach*:

- PPE / IP – Sale of similar properties / market rentals and yields
- Biological assets – Market prices

Key issues are identifying similar assets/liabilities and determining what adjustments to make

The Cost Approach

- The cost approach is based on:
  1. The current cost of replacing the asset;
  2. The asset's current age and condition; and
  3. Any economic or functional obsolescence.
- Sometimes appropriate as a second approach
  - E.g. to check whether income approach results are reasonable

Key issues are finding appropriate replacement costs, particularly for an old asset, and determining the asset's current usefulness. Inappropriate for intangibles in many cases

Income approach

- Also known as the discounted cash flow or DCF approach.
- Includes valuation methods such as
  - Relief From Royalty method.
  - Cost Saving method.
  - Premium Pricing method.
- Widely used to measure:
  - Intangible assets
  - Investment properties
  - CGUs in impairment testing
  - Financial instruments

Key issues are using appropriate cash flows and consistency between cash flow assumptions and discount rate

Valuation techniques – Question?

Entity acquires software that is developed internally using proprietary technologies which are not available to market participants.

Which of the following is the most appropriate valuation technique?

a) Income approach using present value of licence fees = Rs15m

b) Cost approach based on cost to build substitute asset, taking into account obsolescence = Rs10m

EXERCISE 01

Fair Value Hierarchy

SLFRS 13 has a hierarchy for inputs

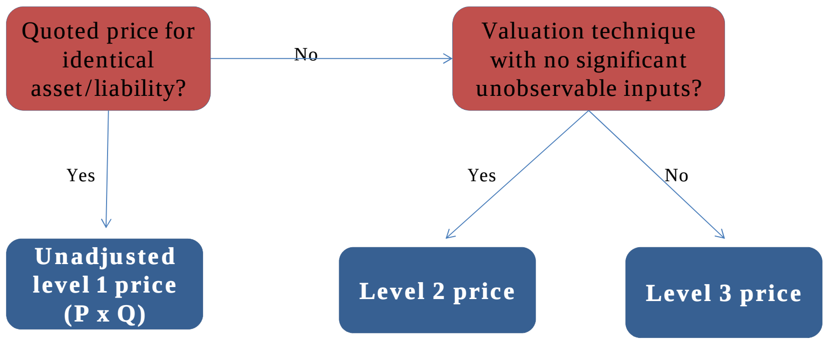
- **Level 1** – Quoted prices (unadjusted) in active markets for identical assets (or liabilities)
- **Level 2** – Inputs, other than Level 1 inputs, that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices)
- **Level 3** – Unobservable inputs

Quoted price in an 'active market' is best indication of fair value

Active market – 'in which transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis'

For disclosure purposes, categorise by reference to the <u>lowest level</u> of inputs which are significant to the entire measurement

Fair value hierarchy



Level 2 Inputs Examples

- **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**
  - Interest rates/yield curves
  - Credit spreads
- **Adjust observable inputs to reflect market participants' assumptions**
  - Comparability of asset with observable items
  - Condition of asset
  - Location of asset
- **Adjustments may convert Level 2 inputs to Level 3 in hierarchy**

Disclosures

- Similar to SLFRS 7, but apply to all assets and liabilities
- Specific requirements to meet the objectives of:
  - disclosing FV techniques and inputs
  - disclosing effect of significant unobservable inputs on P&L/OCI

Disclosures

SLFRS 13 – requirement of paragraph 91

Entity shall disclose information that helps users assess both of the following:

a) 'for assets and liabilities measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements, and

b) for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period

Disclosures

- Increased disclosure requirements for Level 3 compared to Level 1 and 2.
- Disclosure requirements include:
  - Catogarisation by fair value hierarchy
  - Transfers between FV hierarchy, reasons and policy
  - Level 2 & 3 - description of the valuation techniques and inputs used.
  - Changes in valuation techniques used, including reasons
  - Level 3 - a reconciliation of opening to closing balances
  - Level 3 - sensitivity of earnings to unobservable inputs
  - Additional disclosures if current use differ from HABU

Refresher - basics of SLFRS 13

	True or false?
1. SLFRS 13 requires more assets and liabilities to be measured at fair value	FALSE
2. Cost method is usually the best method to value intangible assets.	FALSE
3. Non-financial assets must be measured at their highest and best use.	TRUE
4. An entity can choose whether to use the principal or the most advantageous market.	FALSE
5. An entity is required to measure a financial asset at the bid price.	FALSE

Questions?