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## **Approval by the Board of IFRS 13 issued in May 2011**

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International Financial Reporting Standard 13 *Fair Value Measurement* was approved for issue by the fifteen members of the International Accounting Standards Board.

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## CONTENTS

**BASIS FOR CONCLUSIONS ON IFRS 13  
FAIR VALUE MEASUREMENT**

	<i>from paragraph</i>
<b>INTRODUCTION</b>	<b>BC1</b>
Overview	BC4
Background	BC9
<b>SCOPE</b>	<b>BC19</b>
<b>MEASUREMENT</b>	<b>BC27</b>
Definition of fair value	BC27
The asset or liability	BC46
The transaction	BC48
Market participants	BC55
The price	BC60
Application to non-financial assets	BC63
Application to liabilities	BC80
Application to an entity's own equity instruments	BC104
Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk	BC108
Fair value at initial recognition	BC132
Valuation techniques	BC139
Inputs to valuation techniques	BC149
Fair value hierarchy	BC166
<b>DISCLOSURE</b>	<b>BC183</b>
Distinguishing between recurring and non-recurring fair value measurements	BC186
Information about fair value measurements categorised within Level 3 of the fair value hierarchy	BC187
Transfers between Levels 1 and 2 of the fair value hierarchy	BC211
When an entity uses a non-financial asset in a way that differs from its highest and best use	BC213
The categorisation within the level of the hierarchy for items that are not measured at fair value in the statement of financial position	BC215
Assets with a recoverable amount that is fair value less costs of disposal	BC218
Interim financial reporting	BC222
<b>EFFECTIVE DATE AND TRANSITION</b>	<b>BC225</b>
<b>APPLICATION IN EMERGING AND TRANSITION ECONOMIES</b>	<b>BC231</b>
<b>CONVERGENCE WITH US GAAP</b>	<b>BC236</b>
<b>COST-BENEFIT CONSIDERATIONS</b>	<b>BC239</b>
<b>SUMMARY OF MAIN CHANGES FROM THE EXPOSURE DRAFT</b>	<b>BC244</b>
<b>APPENDIX</b>	
Amendments to the Basis for Conclusions on other IFRSs	

## Basis for Conclusions on IFRS 13 *Fair Value Measurement*

*This Basis for Conclusions accompanies, but is not part of, IFRS 13.*

### Introduction

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- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) in reaching the conclusions in IFRS 13 *Fair Value Measurement*. It includes the reasons for accepting particular views and rejecting others. Individual IASB members gave greater weight to some factors than to others.
- BC2 IFRS 13 is the result of the IASB's discussions about measuring fair value and disclosing information about fair value measurements in accordance with International Financial Reporting Standards (IFRSs), including those held with the US national standard-setter, the Financial Accounting Standards Board (FASB), in their joint project on fair value measurement.
- BC3 As a result of those discussions, the FASB amended particular aspects of Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*<sup>®</sup> (which codified FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157)). The FASB separately developed a Basis for Conclusions summarising its considerations in reaching the conclusions resulting in those amendments.

### Overview

- BC4 Some IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments. Because those IFRSs were developed over many years, the requirements for measuring fair value and for disclosing information about fair value measurements were dispersed and in many cases did not articulate a clear measurement or disclosure objective.
- BC5 As a result, some of those IFRSs contained limited guidance about how to measure fair value, whereas others contained extensive guidance and that guidance was not always consistent across those IFRSs that refer to fair value. Inconsistencies in the requirements for measuring fair value and for disclosing information about fair value measurements have contributed to diversity in practice and have reduced the comparability of information reported in financial statements.
- BC6 To remedy that situation, the IASB added a project to its agenda with the following objectives:
- (a) to establish a single set of requirements for all fair value measurements required or permitted by IFRSs to reduce complexity and improve consistency in their application, thereby enhancing the comparability of information reported in financial statements;
  - (b) to clarify the definition of fair value and related guidance to communicate the measurement objective more clearly;
  - (c) to enhance disclosures about fair value measurements that will help users of financial statements assess the valuation techniques and inputs used to develop fair value measurements; and
  - (d) to increase the convergence of IFRSs and US generally accepted accounting principles (GAAP).
- BC7 IFRS 13 is the result of that project. IFRS 13 is a single source of fair value measurement guidance that clarifies the definition of fair value, provides a clear framework for measuring fair value and enhances the disclosures about fair value measurements. It is also the result of the efforts of the IASB and the FASB to ensure that fair value has the same meaning in IFRSs and in US GAAP and that their respective fair value measurement and disclosure requirements are the same (except for minor differences in wording and style; see paragraphs BC237 and BC238 for the differences between IFRS 13 and Topic 820).
- BC8 IFRS 13 applies to IFRSs that require or permit fair value measurements or disclosures. It does not introduce new fair value measurements, nor does it eliminate practicability exceptions to fair value measurements (eg the exception in IAS 41 *Agriculture* when an entity is unable to measure reliably the fair value of a biological asset on initial recognition). In other words, IFRS 13 specifies *how* an entity should measure fair value and disclose information about fair value measurements. It does not specify *when* an entity should measure an asset, a liability or its own equity instrument at fair value.

## Background

- BC9 The IASB and the FASB began developing their fair value measurement standards separately.
- BC10 The FASB began working on its fair value measurement project in June 2003. In September 2005, during the FASB's redeliberations on the project, the IASB added to its agenda a project to clarify the meaning of fair value and to provide guidance for its application in IFRSs.
- BC11 In September 2006 the FASB issued SFAS 157 (now in Topic 820). Topic 820 defines fair value, establishes a framework for measuring fair value and requires disclosures about fair value measurements.
- BC12 In November 2006 as a first step in developing a fair value measurement standard, the IASB published a discussion paper *Fair Value Measurements*. In that discussion paper, the IASB used SFAS 157 as a basis for its preliminary views because of the consistency of SFAS 157 with the existing fair value measurement guidance in IFRSs and the need for increased convergence of IFRSs and US GAAP. The IASB received 136 comment letters in response to that discussion paper. In November 2007 the IASB began its deliberations for the development of the exposure draft *Fair Value Measurement*.
- BC13 In May 2009 the IASB published that exposure draft, which proposed a definition of fair value, a framework for measuring fair value and disclosures about fair value measurements. Because the proposals in the exposure draft were developed using the requirements of SFAS 157, there were many similarities between them. However, some of those proposals were different from the requirements of SFAS 157 and many of them used wording that was similar, but not identical, to the wording in SFAS 157. The IASB received 160 comment letters in response to the proposals in the exposure draft. One of the most prevalent comments received was a request for the IASB and the FASB to work together to develop common fair value measurement and disclosure requirements in IFRSs and US GAAP.
- BC14 In response to that request, the IASB and the FASB agreed at their joint meeting in October 2009 to work together to develop common requirements. The boards concluded that having common requirements for fair value measurement and disclosure would improve the comparability of financial statements prepared in accordance with IFRSs and US GAAP. In addition, they concluded that having common requirements would reduce diversity in the application of fair value measurement requirements and would simplify financial reporting. To achieve those goals, the boards needed to ensure that fair value had the same meaning in IFRSs and US GAAP and that IFRSs and US GAAP had the same fair value measurement and disclosure requirements (except for minor differences in wording and style). Consequently, the FASB agreed to consider the comments received on the IASB's exposure draft and to propose amendments to US GAAP if necessary.
- BC15 The boards began their joint discussions in January 2010. They discussed nearly all the issues together so that each board would benefit from hearing the rationale for the other board's decisions on each issue. They initially focused on the following:
- (a) differences between the requirements in Topic 820 and the proposals in the IASB's exposure draft;
  - (b) comments received on the IASB's exposure draft (including comments received from participants at the IASB's round-table meetings held in November and December 2009); and
  - (c) feedback received on the implementation of Topic 820 (eg issues discussed by the FASB's Valuation Resource Group).
- BC16 In March 2010 the boards completed their initial discussions. As a result of those discussions, in June 2010 the FASB issued a proposed Accounting Standards Update (ASU) *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* and the IASB re-exposed a proposed disclosure of the unobservable inputs used in a fair value measurement (*Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*). The IASB concluded that it was necessary to re-expose that proposal because in their discussions the boards agreed to require a measurement uncertainty analysis disclosure that included the effect of any interrelationships between unobservable inputs (a requirement that was not proposed in the May 2009 exposure draft and was not already required by IFRSs). The IASB received 92 comment letters on the re-exposure document.
- BC17 In September 2010, after the end of the comment periods on the IASB's re-exposure document and the FASB's proposed ASU, the boards jointly considered the comments received on those exposure drafts. The boards completed their discussions in March 2011.
- BC18 Throughout the process, the IASB considered information from the IFRS Advisory Council, the Analysts' Representative Group and the IASB's Fair Value Expert Advisory Panel (see paragraph BC177) and from other interested parties.

## Scope

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- BC19 The boards separately discussed the scope of their respective fair value measurement standards because of the differences between IFRSs and US GAAP in the measurement bases specified in other standards for both initial recognition and subsequent measurement.
- BC20 IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except in the following circumstances:
- (a) The measurement and disclosure requirements of IFRS 13 do not apply to the following:
    - (i) share-based payment transactions within the scope of IFRS 2 *Share-based Payment*;
    - (ii) leasing transactions within the scope of IAS 17 *Leases*; and
    - (iii) measurements that have some similarities to fair value but are not fair value, such as net realisable value in accordance with IAS 2 *Inventories* and value in use in accordance with IAS 36 *Impairment of Assets*.
  - (b) The disclosures required by IFRS 13 are not required for the following:
    - (i) plan assets measured at fair value in accordance with IAS 19 *Employee Benefits*;
    - (ii) retirement benefit plan investments measured at fair value in accordance with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*; and
    - (iii) assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36.
- BC21 The exposure draft proposed introducing a new measurement basis for IFRS 2, a market-based value. The definition of *market-based value* would have been similar to the exit price definition of fair value except that it would specify that the measurement does not take into account market participant assumptions for vesting conditions and reload features. Respondents pointed out that some items measured at fair value in IFRS 2 were consistent with the proposed definition of fair value, not with the proposed definition of market-based value, and were concerned that there could be unintended consequences of moving forward with a market-based value measurement basis in IFRS 2. The IASB agreed with those comments and concluded that amending IFRS 2 to distinguish between measures that are fair value and those based on fair value would require new measurement guidance for measures based on fair value. The IASB concluded that such guidance might result in unintended changes in practice with regard to measuring share-based payment transactions and decided to exclude IFRS 2 from the scope of IFRS 13.
- BC22 The IASB concluded that applying the requirements in IFRS 13 might significantly change the classification of leases and the timing of recognising gains or losses for sale and leaseback transactions. Because there is a project under way to replace IAS 17, the IASB concluded that requiring entities to make potentially significant changes to their accounting systems for the IFRS on fair value measurement and then for the IFRS on lease accounting could be burdensome.
- BC23 The exposure draft proposed that the disclosures about fair value measurements would be required for the fair value of plan assets in IAS 19 and the fair value of retirement benefit plan investments in IAS 26. In its project to amend IAS 19 the IASB decided to require an entity to disaggregate the fair value of the plan assets into classes that distinguish the risk and liquidity characteristics of those assets, subdividing each class of debt and equity instruments into those that have a quoted market price in an active market and those that do not. As a result, the IASB decided that an entity does not need to provide the disclosures required by IFRS 13 for the fair value of plan assets or retirement benefit plan investments.
- BC24 The exposure draft was not explicit about whether the measurement and disclosure requirements in the exposure draft applied to measurements based on fair value, such as fair value less costs to sell in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* or IAS 41. In the boards' discussions, they concluded that the measurement and disclosure requirements should apply to all measurements for which fair value is the underlying measurement basis (except that the disclosure requirements would not apply to assets with a recoverable amount that is fair value less costs of disposal in IAS 36; see paragraphs BC218–BC221). Consequently, the boards decided to clarify that the measurement and disclosure requirements apply to both fair value measurements and measurements based on fair value. The boards also decided to clarify that the measurement and disclosure requirements do not apply to measurements that have similarities to fair value but are not fair value, such as net realisable value in accordance with IAS 2 or value in use in accordance with IAS 36.
- BC25 The boards decided to clarify that the measurement requirements apply when measuring the fair value of an asset or a liability that is not measured at fair value in the statement of financial position but for which the fair value is disclosed (eg for financial instruments subsequently measured at amortised cost in accordance

with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement* and for investment property subsequently measured using the cost model in accordance with IAS 40 *Investment Property*).

- BC26 The IASB decided that two of the proposals about scope in the exposure draft were not necessary:
- (a) The exposure draft proposed excluding financial liabilities with a demand feature in IAS 39 from the scope of an IFRS on fair value measurement. In the light of the comments received, the IASB confirmed its decision when developing IAS 39 that the fair value of financial liabilities with a demand feature cannot be less than the present value of the demand amount (see paragraphs BC101–BC103) and decided to retain the term *fair value* for such financial liabilities.
  - (b) The exposure draft proposed replacing the term *fair value* with another term that reflects the measurement objective for reacquired rights in a business combination in IFRS 3 *Business Combinations*. In the redeliberations, the IASB concluded that because IFRS 3 already describes the measurement of reacquired rights as an exception to fair value, it was not necessary to change that wording.

## Measurement

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### Definition of fair value

#### Clarifying the measurement objective

- BC27 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.
- BC28 IFRS 13 also provides a framework that is based on an objective 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 (ie an exit price from the perspective of a market participant that holds the asset or owes the liability at the measurement date).
- BC29 That definition of fair value retains the exchange notion contained in the previous definition of fair value in IFRSs:
- The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
- BC30 Like the previous definition of fair value, the revised definition assumes a hypothetical and orderly exchange transaction (ie it is not an actual sale or a forced transaction or distress sale). However, the previous definition of fair value:
- (a) did not specify whether an entity is buying or selling the asset;
  - (b) was unclear about what is meant by settling a liability because it did not refer to the creditor, but to knowledgeable, willing parties; and
  - (c) did not state explicitly whether the exchange or settlement takes place at the measurement date or at some other date.
- BC31 The IASB concluded that the revised definition of fair value remedies those deficiencies. It also conveys more clearly that fair value is a market-based measurement, and not an entity-specific measurement, and that fair value reflects current market conditions (which reflect market participants', not the entity's, current expectations about future market conditions).
- BC32 In determining how to define fair value in IFRSs, the IASB considered work done in its project to revise IFRS 3. In that project, the IASB considered whether differences between the definitions of fair value in US GAAP (an explicit exit price) and IFRSs (an exchange amount, which might be interpreted in some situations as an entry price) would result in different measurements of assets acquired and liabilities assumed in a business combination. That was a particularly important issue because in many business combinations the assets and liabilities are non-financial.
- BC33 The IASB asked valuation experts to take part in a case study involving the valuation of the identifiable assets acquired and liabilities assumed in a sample business combination. The IASB learned that differences between an exit price and an exchange amount (which might be interpreted as an entry price in a business combination) were unlikely to arise, mainly because transaction costs are not a component of fair value in

either definition. The IASB observed that although the definitions used different words, they articulated essentially the same concepts.

- BC34 However, the valuation experts identified potential differences in particular areas. The valuation experts told the IASB that an exit price for an asset acquired or a liability assumed in a business combination might differ from an exchange amount if:
- (a) an entity's intended use for an acquired asset is different from its highest and best use by market participants (ie when the acquired asset provides defensive value); or
  - (b) a liability is measured on the basis of settling it with the creditor rather than transferring it to a third party and the entity determines that there is a difference between those measurements. Paragraphs BC80–BC82 discuss perceived differences between the settlement and transfer notions.
- BC35 With respect to highest and best use, the IASB understood that the ways of measuring assets on the basis of their defensive value (ie the value associated with improving the prospects of the entity's other assets by preventing the acquired asset from being used by competitors) in accordance with US GAAP at the time IFRS 3 was issued were still developing. As a consequence, the IASB thought it was too early to assess the significance of any differences that might result. With respect to liabilities, it was also not clear at that time whether entities would use different valuation techniques to measure the fair value of liabilities assumed in a business combination. In the development of IFRS 13, the IASB observed the discussions of the FASB's Valuation Resource Group to learn from the implementation of SFAS 157 and Topic 820 in US GAAP.

### **Fair value as a current exit price**

- BC36 The definition of fair value in IFRS 13 is a current exit price. That definition in and of itself is not a controversial issue. Many respondents thought the proposal to define fair value as a current, market-based exit price was appropriate because that definition retains the notion of an exchange between unrelated, knowledgeable and willing parties in the previous definition of fair value in IFRSs, but provides a clearer measurement objective. Other respondents thought an entry price would be more appropriate in some situations (eg at initial recognition, such as in a business combination).
- BC37 However, the issue of when fair value should be used as a measurement basis in IFRSs is controversial. There is disagreement about the following:
- (a) which assets and liabilities should be measured at fair value (eg whether fair value should be restricted to assets and liabilities with quoted prices in active markets that the entity intends to sell or transfer in the near term);
  - (b) when those assets and liabilities should be measured at fair value (eg whether the measurement basis should change when markets have become less active); and
  - (c) where any changes in fair value should be recognised.
- BC38 Although IFRS 13 does not address when fair value should be used as a measurement basis for a particular asset or liability or revisit when fair value has been used in IFRSs, the IASB did consider whether each use of the term fair value in IFRSs was consistent with an exit price definition (see paragraphs BC41–BC45). Furthermore, IFRS 13 will inform the IASB in the future as it considers whether to require fair value as a measurement basis for a particular type of asset or liability.
- BC39 The IASB concluded that an exit price of an asset or a liability embodies expectations about the future cash inflows and outflows associated with the asset or liability from the perspective of a market participant that holds the asset or owes the liability at the measurement date. An entity generates cash inflows from an asset by using the asset or by selling it. Even if an entity intends to generate cash inflows from an asset by using it rather than by selling it, an exit price embodies expectations of cash flows arising from the use of the asset by selling it to a market participant that would use it in the same way. That is because a market participant buyer will pay only for the benefits it expects to generate from the use (or sale) of the asset. Thus, the IASB concluded that an exit price is always a relevant definition of fair value for assets, regardless of whether an entity intends to use an asset or sell it.
- BC40 Similarly, a liability gives rise to outflows of cash (or other economic resources) as an entity fulfils the obligation over time or when it transfers the obligation to another party. Even if an entity intends to fulfil the obligation over time, an exit price embodies expectations of related cash outflows because a market participant transferee would ultimately be required to fulfil the obligation. Thus, the IASB concluded that an exit price is always a relevant definition of fair value for liabilities, regardless of whether an entity intends to fulfil the liability or transfer it to another party that will fulfil it.
- BC41 In developing the revised definition of fair value, the IASB completed a standard-by-standard review of fair value measurements required or permitted in IFRSs to assess whether the IASB or its predecessor intended each use of fair value to be a current exit price measurement basis. If it became evident that a current exit

price was not the intention in a particular situation, the IASB would use another measurement basis to describe the objective. The other likely measurement basis candidate was a current entry price. For the standard-by-standard review, the IASB defined current entry price as follows:

The price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants (including the amount imposed on an entity for incurring a liability) at the measurement date.

- BC42 That definition of current entry price, like fair value, assumes a hypothetical orderly transaction between market participants at the measurement date. It is not necessarily the same as the price an entity paid to acquire an asset or received to incur a liability, eg if that transaction was not at arm's length. In discussions with interested parties, the IASB found that most people who assert that an asset or a liability should be measured using an entry price measurement basis, rather than an exit price measurement basis, would actually prefer to use the entity's actual transaction price (or cost), not the market-based current entry price defined above. The IASB observed that in some cases there is not an actual transaction price (eg when a group of assets is acquired but the unit of account is an individual asset, or when a biological asset regenerates) and, as a result, an assumed, or hypothetical, price must be used.
- BC43 During the standard-by-standard review, the IASB asked various parties to provide information on whether, in practice, they interpreted fair value in a particular context in IFRSs as a current entry price or a current exit price. The IASB used that information in determining whether to define fair value as a current exit price, or to remove the term fair value and use the terms current exit price and current entry price depending on the measurement objective in each IFRS that used the term fair value.
- BC44 As a result of the standard-by-standard review, the IASB concluded that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market. Therefore, the IASB considered it unnecessary to make a distinction between a current entry price and a current exit price in IFRSs with a market-based measurement objective (ie fair value), and the IASB decided to retain the term fair value and define it as a current exit price.
- BC45 The IASB concluded that some fair value measurement requirements in IFRSs were inconsistent with a current exit price or the requirements for measuring fair value. For those fair value measurements, IFRS 13 excludes the measurement from its scope (see paragraphs BC19–BC26).

## The asset or liability

- BC46 IFRS 13 states that a fair value measurement takes into account the characteristics of the asset or liability, eg the condition and location of the asset and restrictions, if any, on its sale or use. Restrictions on the sale or use of an asset affect its fair value if market participants would take the restrictions into account when pricing the asset at the measurement date. That is consistent with the fair value measurement guidance already in IFRSs. For example:
- (a) IAS 40 stated that an entity should identify any differences between the property being measured at fair value and similar properties for which observable market prices are available and make the appropriate adjustments; and
  - (b) IAS 41 referred to measuring the fair value of a biological asset or agricultural produce in its present location and condition.
- BC47 The IASB concluded that IFRS 13 should describe how to measure fair value, not what is being measured at fair value. Other IFRSs specify whether a fair value measurement considers an individual asset or liability or a group of assets or liabilities (ie the unit of account). For example:
- (a) IAS 36 states that an entity should measure the fair value less costs of disposal for a cash-generating unit when assessing its recoverable amount.
  - (b) In IAS 39 and IFRS 9 the unit of account is generally an individual financial instrument.

## The transaction

- BC48 The exposure draft proposed that the transaction to sell an asset or transfer a liability takes place in the most advantageous market to which the entity has access. That was different from the approach in Topic 820, which refers to 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. The IASB concluded that in most cases the principal market for an asset or a liability will be the most advantageous market and that an entity need not continuously monitor different markets in order to determine which market is most advantageous at the measurement date. That proposal contained a presumption that the market in which the entity normally enters into

- transactions for the asset or liability is the most advantageous market and that an entity may assume that the principal market for the asset or liability is the most advantageous market.
- BC49 Many respondents agreed with the most advantageous market notion because most entities enter into transactions that maximise the price received to sell an asset or minimise the price paid to transfer a liability. Furthermore, they thought that a most advantageous market notion works best for all assets and liabilities, regardless of the level of activity in a market or whether the market for an asset or a liability is observable.
- BC50 However, some respondents were concerned about the difficulty with identifying and selecting the most advantageous market when an asset or a liability is exchanged in multiple markets throughout the world. Other respondents found the guidance confusing because it was not clear whether the most advantageous market must be used or how the market in which the entity normally enters into transactions relates to the principal market or to the most advantageous market. In general, respondents preferred the approach in Topic 820.
- BC51 Although the boards think that in most cases the principal market and the most advantageous market would be the same, they concluded that the focus should be on the principal market for the asset or liability and decided to clarify the definition of the principal market.
- BC52 Some respondents to the exposure draft stated that the language in US GAAP was unclear about whether the principal market should be determined on the basis of the volume or level of activity *for the asset or liability* or on the volume or level of activity *of the reporting entity's transactions in a particular market*. Consequently, the boards decided to clarify that the principal market is the market for the asset or liability that has the greatest volume or level of activity *for the asset or liability*. Because the principal market is the most liquid market for the asset or liability, that market will provide the most representative input for a fair value measurement. As a result, the boards also decided to specify that a transaction to sell an asset or to transfer a liability takes place in the principal (or most advantageous) market, provided that the entity can access that market on the measurement date.
- BC53 In addition, the boards concluded that an entity normally enters into transactions in the principal market for the asset or liability (ie the most liquid market, assuming that the entity can access that market). As a result, the boards decided to specify that an entity can use the price in the market in which it normally enters into transactions, unless there is evidence that the principal market and that market are not the same. Consequently, an entity does not need to perform an exhaustive search for markets that might have more activity for the asset or liability than the market in which that entity normally enters into transactions. Thus, IFRS 13 addresses practical concerns about the costs of searching for the market with the greatest volume or level of activity for the asset or liability.
- BC54 The boards also concluded that the determination of the most advantageous market (which is used in the absence of a principal market) for an asset or a liability takes into account both transaction costs and transport costs. However, regardless of whether an entity measures fair value on the basis of the price in the principal market or in the most advantageous market, the fair value measurement takes into account transport costs, but not transaction costs (see paragraphs BC60–BC62 for a discussion on transport and transaction costs). That is consistent with the proposal in the exposure draft.

## Market participants

- BC55 IFRS 13 states that a fair value measurement is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement uses the assumptions that market participants would use when pricing the asset or liability.
- BC56 The previous definition of fair value in IFRSs referred to 'knowledgeable, willing parties in an arm's length transaction'. The IASB concluded that the previous definition expressed the same notion as the definition of fair value in IFRS 13, but that the previous definition was less clear. Thus, IFRS 13 defines market participants as buyers and sellers in the principal (or most advantageous) market for the asset or liability who are independent of each other (ie they are not related parties), knowledgeable about the asset or liability, and able and willing to enter into a transaction for the asset or liability.

## Independence

- BC57 IFRS 13 states that market participants are independent of each other (ie they are not related parties). That is consistent with the proposal in the exposure draft. Given that proposal, some respondents noted that in some jurisdictions entities often have common ownership (eg state-owned enterprises or entities with cross ownership) and questioned whether transactions observed in those jurisdictions would be permitted as an input into a fair value measurement. The boards decided to clarify that the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence

that the transaction was entered into at market terms. The boards concluded that this is consistent with IAS 24 *Related Party Disclosures*.

## Knowledge

- BC58 The exposure draft stated that market participants were presumed to be as knowledgeable as the entity about the asset or liability. Some respondents questioned that conclusion because they thought the entity might have access to information that is not available to other market participants (information asymmetry).
- BC59 In the IASB's view, if a market participant is willing to enter into a transaction for an asset or a liability, it would undertake efforts, including usual and customary due diligence efforts, necessary to become knowledgeable about the asset or liability and would factor any related risk into the measurement.

## The price

- BC60 IFRS 13 states that the price used to measure fair value should not be reduced (for an asset) or increased (for a liability) by the costs an entity would incur when selling the asset or transferring the liability (ie transaction costs).
- BC61 Some respondents stated that transaction costs are unavoidable when entering into a transaction for an asset or a liability. However, the IASB noted that the costs may differ depending on how a particular entity enters into a transaction. Therefore, the IASB concluded that transaction costs are not a characteristic of an asset or a liability, but a characteristic of the transaction. That decision is consistent with the requirements for measuring fair value already in IFRSs. An entity accounts for those costs in accordance with relevant IFRSs.
- BC62 Transaction costs are different from transport costs, which are the costs that would be incurred to transport the asset from its current location to its principal (or most advantageous) market. Unlike transaction costs, which arise from a transaction and do not change the characteristics of the asset or liability, transport costs arise from an event (transport) that does change a characteristic of an asset (its location). IFRS 13 states that if location is a characteristic of an asset, the price in the principal (or most advantageous) market should be adjusted for the costs that would be incurred to transport the asset from its current location to that market. That is consistent with the fair value measurement guidance already in IFRSs. For example, IAS 41 required an entity to deduct transport costs when measuring the fair value of a biological asset or agricultural produce.

## Application to non-financial assets

### Distinguishing between financial assets, non-financial assets and liabilities

- BC63 The exposure draft stated that the concepts of highest and best use and valuation premise would not apply to financial assets or to liabilities.

The IASB reached that conclusion for the following reasons:

- (a) Financial assets do not have alternative uses because a financial asset has specific contractual terms and can have a different use only if the characteristics of the financial asset (ie the contractual terms) are changed. However, a change in characteristics causes that particular asset to become a different asset. The objective of a fair value measurement is to measure the asset that exists at the measurement date.
  - (b) Even though an entity may be able to change the cash flows associated with a liability by relieving itself of the obligation in different ways, the different ways of doing so are not alternative uses. Moreover, although an entity might have entity-specific advantages or disadvantages that enable it to fulfil a liability more or less efficiently than other market participants, those entity-specific factors do not affect fair value.
  - (c) Those concepts were originally developed within the valuation profession to value non-financial assets, such as land.
- BC64 Before the amendments to Topic 820, US GAAP specified that the concepts of highest and best use and valuation premise applied when measuring the fair value of assets, but it did not distinguish between financial assets and non-financial assets.
- BC65 The FASB agreed with the IASB that the concepts of highest and best use and valuation premise are relevant when measuring the fair value of non-financial assets, and are not relevant when measuring the fair value of financial assets or the fair value of liabilities. The boards also concluded that those concepts

do not apply to an entity's own equity instruments because those arrangements, similar to financial instruments, typically have specific contractual terms. Paragraphs BC108–BC131 describe the boards' rationale in developing the requirements for measuring the fair value of financial assets and financial liabilities with offsetting positions in market risks and counterparty credit risk.

- BC66 Some respondents to the FASB's proposed ASU were concerned that limiting the highest and best use concept to non-financial assets removed the concept of value maximisation by market participants, which they considered fundamental to a fair value measurement for financial assets and financial liabilities.
- BC67 The boards decided to clarify that although there are no excess returns available from holding financial assets and financial liabilities within a portfolio (because in an efficient market, the price reflects the benefits that market participants would derive from holding the asset or liability in a diversified portfolio), a fair value measurement assumes that market participants seek to maximise the fair value of a financial or non-financial asset or to minimise the fair value of a financial or non-financial liability by acting in their economic best interest in a transaction to sell the asset or to transfer the liability in the principal (or most advantageous) market for the asset or liability. Such a transaction might involve grouping assets and liabilities in a way in which market participants would enter into a transaction, if the unit of account in other IFRSs does not prohibit that grouping.

### Highest and best use

- BC68 Highest and best use is a valuation concept used to value many non-financial assets (eg real estate). The highest and best use of a non-financial asset must be physically possible, legally permissible and financially feasible. In developing the proposals in the exposure draft, the IASB concluded that it was necessary to describe those three criteria, noting that US GAAP at the time did not.
- BC69 Some respondents asked for further guidance about whether a use that is legally permissible must be legal at the measurement date, or if, for example, future changes in legislation can be taken into account. The IASB concluded that a use of an asset does not need to be legal at the measurement date, but must not be legally prohibited in the jurisdiction (eg if the government of a particular country has prohibited building or development in a protected area, the highest and best use of the land in that area could not be to develop it for industrial use). The illustrative examples that accompany IFRS 13 show how an asset can be zoned for a particular use at the measurement date, but how a fair value measurement can assume a different zoning if market participants would do so (incorporating the cost to convert the asset and obtain that different zoning permission, including the risk that such permission would not be granted).
- BC70 IFRS 13 states that fair value takes into account the highest and best use of an asset from the perspective of market participants. That is the case even if an entity acquires an asset but, to protect its competitive position or for other reasons, the entity does not intend to use it actively or does not intend to use the asset in the same way as other market participants (eg if an intangible asset provides defensive value because the acquirer holds the asset to keep it from being used by competitors). When revising IFRS 3 in 2008, the IASB decided that an entity must recognise such an asset at fair value because the intention of IFRS 3 was that assets, both tangible and intangible, should be measured at their fair values regardless of how or whether the acquirer intends to use them (see paragraph BC262 of IFRS 3). IFRS 13 sets out requirements for measuring the fair value of those assets.
- BC71 IFRS 13 does not require an entity to perform an exhaustive search for other potential uses of a non-financial asset if there is no evidence to suggest that the current use of an asset is not its highest and best use. The IASB concluded that an entity that seeks to maximise the value of its assets would use those assets at their highest and best use and that it would be necessary for an entity to consider alternative uses of those assets only if there was evidence that the current use of the assets is not their highest and best use (ie an alternative use would maximise their fair value). Furthermore, after discussions with valuation professionals, the IASB concluded that in many cases it would be unlikely for an asset's current use not to be its highest and best use after taking into account the costs to convert the asset to the alternative use.
- BC72 When the IASB was developing the proposals in the exposure draft, users of financial statements asked the IASB to consider how to account for assets when their highest and best use within a group of assets is different from their current use by the entity (ie when there is evidence that the current use of the assets is not their highest and best use, and an alternative use would maximise their fair value). For example, the fair value of a factory is linked to the value of the land on which it is situated. The fair value of the factory would be nil if the land has an alternative use that assumes the factory is demolished. The IASB concluded when developing the exposure draft that measuring the factory at nil would not provide useful information when an entity is using that factory in its operations. In particular, users would want to see depreciation on that factory so that they could assess the economic resources consumed in generating cash flows from its operation. Therefore, the exposure draft proposed requiring an entity to separate the fair value of the asset group into its current use and fair value components.

- BC73 Respondents found that proposal confusing and thought that calculating two values for a non-financial asset would be costly. As a result, the boards decided that when an entity uses a non-financial asset in a way that differs from its highest and best use (and that asset is measured at fair value), the entity must simply disclose that fact and why the asset is being used in a manner that differs from its highest and best use (see paragraphs BC213 and BC214).

## Valuation premise

### *Terminology*

- BC74 As an application of the highest and best use concept, the exposure draft identified two valuation premises that may be relevant when measuring the fair value of an asset:
- (a) The *in-use valuation premise*, which applies when the highest and best use of an asset is to use it with other assets or with other assets and liabilities as a group. The in-use valuation premise assumes that the exit price would be the price for a sale to a market participant that has, or can obtain, the other assets and liabilities needed to generate cash inflows by using the asset (complementary assets and the associated liabilities).
  - (b) The *in-exchange valuation premise*, which applies when the highest and best use of an asset is to use it on a stand-alone basis. It assumes that the sale would be to a market participant that uses the asset on a stand-alone basis.
- BC75 Many respondents found the terms *in use* and *in exchange* confusing because they thought that the terminology did not accurately reflect the objective of the valuation premise (ie in both cases the asset is being exchanged, and both cases involve an assessment of how the asset will be used by market participants). In addition, some respondents stated that the in-use valuation premise could be confused with the term *value in use*, as defined in IAS 36.
- BC76 In response, the boards decided to remove the terms *in use* and *in exchange* and instead describe the objective of the valuation premise: the valuation premise assumes that an asset would be used either (a) in combination with other assets or with other assets and liabilities (formerly referred to as *in use*) or (b) on a stand-alone basis (formerly referred to as *in exchange*). Respondents to the FASB's proposed ASU generally supported that proposal. The boards concluded that the change improves the understandability of the valuation premise concept.

### *Valuation premise for a single non-financial asset*

- BC77 IFRS 13 states that the valuation premise assumes that the non-financial asset being measured at fair value is sold on its own (at the unit of account level) and should be measured accordingly, even if transactions in the asset are typically the result of sales of the asset as part of a group of assets or a business. Even when an asset is used in combination with other assets, the exit price for the asset is a price for that asset individually because a fair value measurement assumes that a market participant (buyer) of the asset already holds the complementary assets and the associated liabilities. Because the buyer is assumed to hold the other assets (and liabilities) necessary for the asset to function, that buyer would not be willing to pay more for the asset solely because it was sold as part of a group. That conclusion is consistent with the conclusion reached in IFRS 3 for measuring the fair value of the identifiable assets acquired in a business combination.

### *Valuation premise for specialised non-financial assets*

- BC78 Some respondents to the exposure draft expressed concerns about using an exit price notion for specialised non-financial assets that have a significant value when used together with other non-financial assets, for example in a production process, but have little value if sold for scrap to another market participant that does not have the complementary assets. They were concerned that an exit price would be based on that scrap value (particularly given the requirement to maximise the use of observable inputs, such as market prices) and would not reflect the value that an entity expects to generate by using the asset in its operations. However, IFRS 13 clarifies that this is not the case. In such situations, the scrap value for an individual asset would be irrelevant because the valuation premise assumes that the asset would be used in combination with other assets or with other assets and liabilities. Therefore, an exit price reflects the sale of the asset to a market participant that has, or can obtain, the complementary assets and the associated liabilities needed to use the specialised asset in its own operations. In effect, the market participant buyer steps into the shoes of the entity that holds that specialised asset.
- BC79 It is unlikely in such a situation that a market price, if available, would capture the value that the specialised asset contributes to the business because the market price would be for an unmodified asset. When a market price does not capture the characteristics of the asset (eg if that price represents the use of the asset on a stand-alone basis, not installed or otherwise configured for use, rather than in combination with other assets, installed

and configured for use), that price will not represent fair value. In such a situation, an entity will need to measure fair value using another valuation technique (such as an income approach) or the cost to replace or recreate the asset (such as a cost approach) depending on the circumstances and the information available.

## Application to liabilities

### General principles

- BC80 The exposure draft proposed that a fair value measurement assumes that a liability is transferred to a market participant at the measurement date because the liability that is the subject of the fair value measurement remains outstanding (ie it is owed by the entity and is not settled with the counterparty or otherwise extinguished at the measurement date). Because the liability is assumed to be transferred to a market participant, the liability remains outstanding and the market participant transferee, like the entity, would be required to fulfil it. The same concept applies to an entity's own equity instrument, as discussed in paragraphs BC104–BC107.
- BC81 In many cases, an entity might not intend (or be able) to transfer its liability to a third party. For example, an entity might have advantages relative to the market that would make it more beneficial for the entity to fulfil the liability using its own internal resources or the counterparty might not permit the liability to be transferred to another party. However, the IASB concluded that a fair value measurement provides a market benchmark to use as a basis for assessing an entity's advantages or disadvantages in performance or settlement relative to the market (for both assets and liabilities). Therefore, when a liability is measured at fair value, the relative efficiency of an entity in settling the liability using its own internal resources appears in profit or loss over the course of its settlement, and not before.
- BC82 Furthermore, even if an entity is unable to transfer its liability to a third party, the IASB concluded that the transfer notion was necessary in a fair value measurement because that notion captures market participants' expectations about the liquidity, uncertainty and other factors associated with the liability, whereas a settlement notion may not because it may incorporate entity-specific factors. In the IASB's view, the fair value of a liability from the perspective of a market participant that owes the liability is the same regardless of whether it is settled or transferred. That is because:
- (a) both a settlement and a transfer of a liability reflect all costs that would be incurred to fulfil the obligation, including the market-based profit an entity and a market participant transferee desire to earn on all their activities.
  - (b) an entity faces the same risks when fulfilling an obligation that a market participant transferee faces when fulfilling that obligation. Neither the entity nor the market participant transferee has perfect knowledge about the timing and amount of the cash outflows, even for financial liabilities.
  - (c) a settlement in a fair value measurement does not assume a settlement with the counterparty over time (eg as principal and interest payments become due), but a settlement at the measurement date. Accordingly, the settlement amount in a fair value measurement reflects the present value of the economic benefits (eg payments) the counterparty would have received over time.
- As a result, the IASB concluded that similar thought processes are needed to estimate both the amount to settle a liability and the amount to transfer that liability.
- BC83 The exposure draft proposed that an entity could estimate the amount at which a liability could be transferred in a transaction between market participants by using the same methodology that would be used to measure the fair value of the liability held by another entity as an asset (ie the fair value of the corresponding asset). If the liability was traded as an asset, the observed price would also represent the fair value of the issuer's liability. If there was no corresponding asset (eg as would be the case with a decommissioning liability), the fair value of the liability could be measured using a valuation technique, such as the present value of the future cash outflows that market participants would expect to incur in fulfilling the obligation.
- BC84 That proposal was consistent with the approach in Topic 820 in US GAAP (in August 2009, after the IASB's exposure draft was published, the FASB amended Topic 820 to provide additional guidance about measuring the fair value of liabilities). However, Topic 820 provided more guidance than the IASB's exposure draft, including additional examples for applying that guidance. Because the guidance in Topic 820 was consistent with but not identical to the proposals in the IASB's exposure draft, the boards worked together to develop a combination of the two.
- BC85 The boards concluded that the objective of a fair value measurement of a liability when using a valuation technique (ie when there is not an observable market to provide pricing information about the transfer of the liability) is to estimate the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date under current market conditions.

- BC86 Therefore, the boards decided to describe how an entity should measure the fair value of a liability when there is no observable market to provide pricing information about the transfer of a liability. For example, IFRS 13 states that an entity may measure the fair value of a liability by using a quoted price for an identical or a similar liability held by another party as an asset or by using another valuation technique (such as an income approach).
- BC87 The boards clarified that regardless of the approach used, when there is no observable market price for the transfer of a liability and the identical liability is held by another party as an asset, an entity measures the fair value of the liability from the perspective of a market participant that holds the identical liability as an asset at the measurement date. That approach is consistent with the exposure draft and US GAAP.
- BC88 Thus, in the boards' view, the fair value of a liability equals the fair value of a properly defined corresponding asset (ie an asset whose features mirror those of the liability), assuming an exit from both positions in the same market. In reaching their decision, the boards considered whether the effects of illiquidity could create a difference between those values. The boards noted that the effects of illiquidity are difficult to differentiate from credit-related effects. The boards concluded that there was no conceptual reason why the liability value would diverge from the corresponding asset value in the same market because the contractual terms are the same, unless the unit of account for the liability is different from the unit of account for the asset or the quoted price for the asset relates to a similar (but not identical) liability held as an asset.
- BC89 Furthermore, the boards concluded that in an efficient market, the price of a liability held by another party as an asset must equal the price for the corresponding asset. If those prices differed, the market participant transferee (ie the party taking on the obligation) would be able to earn a profit by financing the purchase of the asset with the proceeds received by taking on the liability. In such cases the price for the liability and the price for the asset would adjust until the arbitrage opportunity was eliminated.
- BC90 The exposure draft stated that when using a present value technique to measure the fair value of a liability that is not held by another party as an asset, an entity should include the compensation that a market participant would require for taking on the obligation. Topic 820 contained such a requirement. Respondents asked for clarification on the meaning of compensation that a market participant would require for taking on the obligation. Therefore, the boards decided to provide additional guidance about the compensation that market participants would require, such as the compensation for taking on the responsibility of fulfilling an obligation and for assuming the risk associated with an uncertain obligation (ie the risk that the actual cash outflows might differ from the expected cash outflows). The boards concluded that including this description will improve the application of the requirements for measuring the fair value of liabilities that are not held as assets.
- BC91 Some respondents to the FASB's proposed ASU requested clarification about applying risk premiums when measuring the fair value of a liability that is not held by another party as an asset (eg a decommissioning liability assumed in a business combination) when using a present value technique. They noted that the description of present value techniques described adjustments for risk as *additions* to the discount rate, which they agreed was consistent with asset valuation, but not necessarily consistent with liability valuation in the absence of a corresponding asset. The boards reasoned that from a market participant's perspective, compensation for the uncertainty related to a liability results in an increase to the amount that the market participant would expect to receive for assuming the obligation. If that compensation was accounted for in the discount rate, rather than in the cash flows, it would result in a reduction of the discount rate used in the fair value measurement of the liability. Therefore, the boards concluded that, all else being equal, the risk associated with an asset decreases the fair value of that asset, whereas the risk associated with a liability increases the fair value of that liability. However, the boards decided not to prescribe how an entity would adjust for the risk inherent in an asset or a liability, but to state that the objective is to ensure that the fair value measurement takes that risk into account. That can be done by adjusting the cash flows or the discount rate or by adding a risk adjustment to the present value of the expected cash flows (which is another way of adjusting the cash flows).

### Non-performance risk

- BC92 IFRS 13 states that a fair value measurement assumes that the fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation. Non-performance risk includes, but is not limited to, an entity's own credit risk (credit standing). That is consistent with the fair value measurement guidance already in IFRSs. For example, IAS 39 and IFRS 9 referred to making adjustments for credit risk if market participants would reflect that risk when pricing a financial instrument. However, there was inconsistent application of that principle because:
- (a) IAS 39 and IFRS 9 refer to credit risk generally and do not specifically refer to the reporting entity's *own* credit risk; and

- (b) there were different interpretations about how an entity's own credit risk should be reflected in the fair value of a liability using the settlement notion in the previous definition of fair value because it is unlikely that the counterparty would accept a different amount as settlement of the obligation if the entity's credit standing changed.

BC93 As a result, some entities took into account changes in their own credit risk when measuring the fair value of their liabilities, whereas other entities did not. Consequently, the IASB decided to clarify in IFRS 13 that the fair value of a liability includes an entity's own credit risk.

BC94 In a fair value measurement, the non-performance risk related to a liability is the same before and after its transfer. Although the IASB acknowledges that such an assumption is unlikely to be realistic for an actual transaction (because in most cases the reporting entity transferor and the market participant transferee are unlikely to have the same credit standing), the IASB concluded that such an assumption was necessary when measuring fair value for the following reasons:

- (a) A market participant taking on the obligation would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price (eg a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor if those terms reflect the transferor's lower credit standing).
- (b) Without specifying the credit standing of the entity taking on the obligation, there could be fundamentally different fair values for a liability depending on an entity's assumptions about the characteristics of the market participant transferee.
- (c) Those who might hold the entity's obligations as assets would consider the effect of the entity's credit risk and other risk factors when pricing those assets (see paragraphs BC83–BC89).

The FASB reached the same conclusions when developing SFAS 157 and ASU No. 2009-05 *Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value*.

BC95 Few respondents questioned the usefulness of reflecting non-performance risk in the fair value measurement of a liability at initial recognition. However, many questioned the usefulness of doing so after initial recognition, because they reasoned that it would lead to counter-intuitive and potentially confusing reporting (ie gains for credit deterioration and losses for credit improvements). The IASB understands that these concerns are strongly held, but concluded that addressing them was beyond the scope of the fair value measurement project. The purpose of that project was to define fair value, not to determine when to use fair value or how to present changes in fair value. A measurement that does not consider the effect of an entity's non-performance risk is not a fair value measurement. The IASB addressed those concerns in developing IFRS 9 (issued in October 2010).

### *Liabilities issued with third-party credit enhancements*

BC96 IFRS 13 includes requirements for measuring the fair value of a liability issued with an inseparable third-party credit enhancement from the issuer's perspective. Those requirements are consistent with Topic 820.

BC97 A credit enhancement (also referred to as a guarantee) may be purchased by an issuer that combines it with a liability, such as debt, and then issues the combined security to an investor. For example, debt may be issued with a financial guarantee from a third party that guarantees the issuer's payment obligations. Generally, if the issuer of the liability fails to meet its payment obligations to the investor, the guarantor has an obligation to make the payments on the issuer's behalf and the issuer has an obligation to the guarantor. By issuing debt combined with a credit enhancement, the issuer is able to market its debt more easily and can either reduce the interest rate paid to the investor or receive higher proceeds when the debt is issued.

BC98 The boards concluded that the measurement of a liability should follow the unit of account of the liability for financial reporting purposes. When the unit of account for such liabilities is the obligation without the credit enhancement, the fair value of the liability from the issuer's perspective will not equal its fair value as a guaranteed liability held by another party as an asset. Therefore, the fair value of the guaranteed liability held by another party as an asset would need to be adjusted because any payments made by the guarantor in accordance with the guarantee result in a transfer of the issuer's debt obligation from the investor to the guarantor. The issuer's resulting debt obligation to the guarantor has not been guaranteed. Consequently, the boards decided that if the third-party credit enhancement is accounted for separately from the liability, the fair value of that obligation takes into account the credit standing of the issuer and not the credit standing of the guarantor.

## Restrictions preventing transfer

- BC99 A restriction on an entity's ability to transfer its liability to another party is a function of the requirement to fulfil the obligation and the effect of such a restriction normally is already reflected in the price. As a result, IFRS 13 states that the fair value of a liability should not be adjusted further for the effect of a restriction on its transfer if that restriction is already included in the other inputs to the fair value measurement. However, if an entity is aware that a restriction on transfer is not already reflected in the price (or in the other inputs used in the measurement), the entity would adjust those inputs to reflect the existence of the restriction.
- BC100 The boards concluded that there are two fundamental differences between the fair value measurement of an asset and the fair value measurement of a liability that justify different treatments for asset restrictions and liability restrictions. First, restrictions on the transfer of a liability relate to the performance of the obligation (ie the entity is legally obliged to satisfy the obligation and needs to do something to be relieved of the obligation), whereas restrictions on the transfer of an asset relate to the marketability of the asset. Second, nearly all liabilities include a restriction preventing the transfer of the liability, whereas most assets do not include a similar restriction. As a result, the effect of a restriction preventing the transfer of a liability, theoretically, would be consistent for all liabilities and, therefore, would require no additional adjustment beyond the factors considered in determining the original transaction price. The inclusion of a restriction preventing the sale of an asset typically results in a lower fair value for the restricted asset than for the non-restricted asset, all other factors being equal.

## Measurement of financial liabilities with a demand feature

- BC101 In developing IFRS 13, the IASB confirmed its decision in developing IAS 39 that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be repaid.
- BCZ102 Some comments received on the exposure draft published in 2002 preceding IAS 39 requested clarification of how to measure the fair value of financial liabilities with a demand feature (eg demand deposits) when the fair value measurement option is applied or the liability is otherwise measured at fair value. In other words, could the fair value be less than the amount payable on demand, discounted from the first date that an amount could be required to be paid (the demand amount), such as the amount of the deposit discounted for the period that the entity expects the deposit to be outstanding? Some commentators believed that the fair value of financial liabilities with a demand feature is less than the demand amount, for reasons that include the consistency of such measurement with how those financial liabilities are treated for risk management purposes.
- BCZ103 In developing IAS 39 the IASB agreed that this issue should be clarified. It confirmed that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (this is now in paragraph 47 of IFRS 13). That conclusion is the same as in the original IAS 32 *Financial Instruments: Disclosure and Presentation* (issued by the IASB's predecessor body, IASC, in 1995), which is now IAS 32 *Financial Instruments: Presentation*. The IASB noted that in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—ie the demand amount. It also noted that recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the IASB believes is inappropriate.

## Application to an entity's own equity instruments

- BC104 The exposure draft and Topic 820 stated that although the definition of fair value refers to assets and liabilities, it also should be applied to an instrument measured at fair value that is classified in an entity's own shareholders' equity. Respondents to the discussion paper asked for explicit guidance for measuring the fair value of such instruments because Topic 820 did not contain explicit guidance. Consequently, the boards decided to describe how an entity should measure the fair value of its own equity instruments (eg when an acquirer issues equity in consideration for an acquiree in a business combination).
- BC105 The exposure draft proposed requiring an entity to measure the fair value of its own equity instruments from the perspective of a market participant that holds the instrument as an asset. That was because the issuer of an equity instrument can exit from that instrument only if the instrument ceases to exist or if the entity repurchases the instrument from the holder. The FASB agreed with that conclusion.
- BC106 The boards also noted that some instruments may be classified as liabilities or equity, depending on the characteristics of the transaction and the characteristics of the instrument. Examples of such instruments include contingent consideration issued in a business combination in accordance with IFRS 3 and equity warrants issued by an entity in accordance with IAS 39 or IFRS 9. The boards concluded that the

requirements for measuring the fair value of an entity's own equity instruments should be consistent with the requirements for measuring the fair value of liabilities. Consequently, the boards decided to clarify that the accounting classification of an instrument should not affect that instrument's fair value measurement.

- BC107 The boards decided to clarify that the objective of a fair value measurement for liabilities and an entity's own equity instruments should be an exit price from the perspective of a market participant that holds the instrument as an asset at the measurement date if there is a corresponding asset, regardless of whether there is an observable market for the instrument as an asset. That decision is consistent with the boards' decisions about the requirements for measuring the fair value of a liability.

## **Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk**

- BC108 An entity that holds a group of financial assets and financial liabilities is exposed to market risks (ie interest rate risk, currency risk or other price risk) and to the credit risk of each of the counterparties. Financial institutions and similar entities that hold financial assets and financial liabilities often manage those instruments on the basis of the entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty.
- BC109 The previous requirements in IFRSs and US GAAP for measuring the fair value of financial assets and financial liabilities that are managed in this way were expressed differently. Therefore, the boards concluded that it is important that IFRSs and US GAAP express the requirements for measuring the fair value of those financial instruments in the same way.
- BC110 When applying IFRSs, entities applied IFRS 9 or IAS 39, which permitted an entity to take into account the effects of offsetting positions in the same market risk (or risks) when measuring the fair value of a financial asset or financial liability. Many entities were using the same approach for offsetting positions in the credit risk of a particular counterparty by analogy.
- BC111 When applying US GAAP, many entities applied the in-use valuation premise when measuring the fair value of such financial assets and financial liabilities. In other words, an entity would take into account how the fair value of each financial asset or financial liability might be affected by the combination of that asset or liability with other financial assets or financial liabilities held by the entity. Other entities applied the in-exchange valuation premise to the entity's net risk exposure and assumed that the transaction took place for the net position, not for the individual assets and liabilities making up that position. Those differing applications of the valuation premise arose because Topic 820 did not specify the valuation premise for financial assets.
- BC112 In developing the exposure draft, the IASB concluded that the fair value of a financial asset reflects any benefits that market participants would derive from holding that asset within a diversified portfolio. An entity derives no incremental value from holding a financial asset within a portfolio. Furthermore, the IASB noted that the valuation premise related only to assets, not to liabilities, and as such could not be applied to portfolios of financial instruments that include financial liabilities. Therefore, the exposure draft proposed that the in-exchange valuation premise must be used to measure the fair value of a financial asset. The IASB also proposed an amendment to IAS 39 making it explicit that the unit of account for financial instruments is the individual financial instrument at all levels of the fair value hierarchy (Level 1, 2 or 3).
- BC113 The boards understand that although the approaches used to measure the fair value of financial assets and financial liabilities were expressed differently in IFRSs and US GAAP, they resulted in similar fair value measurement conclusions in many cases. However, the FASB was aware that before the amendments Topic 820 was sometimes interpreted more broadly than the FASB intended, such as when an entity used the in-use valuation premise to measure the fair value of a group of financial assets when the entity did not have offsetting positions in a particular market risk (or risks) or counterparty credit risk. That interpretation led the IASB to propose requiring the in-exchange valuation premise for financial assets in its exposure draft.
- BC114 The IASB's proposal to require the fair value of a financial asset to be measured using the in-exchange valuation premise was one of the more controversial proposals in the exposure draft. That proposal, combined with a proposed amendment to IAS 39 about the unit of account for financial instruments, led respondents to believe that the fair value of financial assets cannot reflect the fact that those assets are held within a portfolio, even when an entity manages its financial instruments on the basis of the entity's net exposure, rather than its gross exposure, to market risks and credit risk.
- BC115 Respondents were concerned that the proposal in the exposure draft would separate the valuation of financial instruments for financial reporting from the entity's internal risk management practices. In addition, they were concerned about the systems changes that would be necessary to effect a change in practice. To preserve the relationship between financial reporting and risk management, some respondents asked whether they would be able to apply the bid-ask spread guidance to each of the individual instruments so that the sum of the fair values of the individual instruments equals the value of the net position.

BC116 Other respondents suggested that the IASB should continue to allow the practice that has developed using paragraph AG72 of IAS 39, which stated:

When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate.

BC117 The previous requirements in IFRSs and US GAAP did not clearly specify the relationship between the fair value measurement of financial instruments and how an entity manages its net risk exposure. For example, Topic 820, IAS 39 and IFRS 9 did not explicitly address how the following meet the objective of a fair value measurement for financial instruments:

- (a) Entities typically do not manage their exposure to market risks and credit risk by *selling* a financial asset or transferring a financial liability (eg by unwinding a transaction). Instead, they manage their risk exposure by entering into a transaction for another financial instrument (or instruments) that would result in an offsetting position in the same risk. The resulting measurement represents the fair value of the net risk exposure, not the fair value of an individual financial instrument. The sum of the fair values of the individual instruments is not equal to the fair value of the net risk exposure.
- (b) An entity's net risk exposure is a function of the other financial instruments held by the entity and of the entity's risk preferences (both of which are entity-specific decisions and, thus, do not form part of a fair value measurement). Market participants may hold different groups of financial instruments or may have different risk preferences, and it is those factors that are taken into account when measuring fair value. However, the boards understand that market participants holding that particular group of financial instruments and with those particular risk preferences would be likely to price those financial instruments similarly (ie using similar valuation techniques and similar market data). As a result, the market participants' measurement of those financial instruments within that particular group is a market-based measurement, and a measurement using an entity's risk preferences would not be a fair value measurement, but an entity-specific measurement.

BC118 Consequently, the boards decided to permit an exception to the requirements in IFRS 13 and Topic 820 for measuring fair value when an entity manages its financial assets and financial liabilities on the basis of the entity's net exposure to market risks or to the credit risk of a particular counterparty. Respondents to the FASB's proposed ASU generally supported that proposal and stated that it was consistent with current practice for measuring the fair value of such financial assets and financial liabilities.

BC119 That exception permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (ie asset) for a particular risk exposure or to transfer a net short position (ie liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions, subject to specific requirements.

### *Evidence of managing financial instruments on the basis of the net risk exposure*

BC120 IFRS 13 states that to use the exception, an entity must provide evidence that it consistently manages its financial instruments on the basis of its net exposure to market risks or credit risk. In addition, the entity must be required (or must have elected, for example, in accordance with the fair value option) to measure the financial instruments at fair value on a recurring basis. The boards concluded that if an entity does not manage its risk exposure on a net basis and does not manage its financial instruments on a fair value basis, the entity should not be permitted to measure the fair value of its financial instruments on the basis of the entity's net risk exposure.

BC121 The boards decided to require an entity to provide evidence that it manages its net risk exposure consistently from period to period. The boards decided this because an entity that can provide evidence that it manages its financial instruments on the basis of its net risk exposure would do so consistently for a particular portfolio from period to period, and not on a net basis for that portfolio in some periods and on a gross basis in other periods. Some respondents to the FASB's proposed ASU found that requirement limiting because they noted that the composition of a portfolio changes continually as the entity rebalances the portfolio and changes its risk exposure preferences over time. Although the entity does not need to maintain a static portfolio, the boards decided to clarify that the entity must make an accounting policy decision (in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) to use the exception described in paragraphs BC118 and BC119. The boards also decided that the accounting policy decision could be changed if the entity's risk exposure preferences change. In that case the entity can decide not to use the exception but instead to measure the fair value of its financial instruments on an individual instrument basis. However, if the entity continues to value a portfolio using the exception, it must do so consistently from period to period.

*Exposure to market risks*

- BC122 The boards decided that an entity could apply the bid-ask spread guidance to the entity's net position in a particular market risk (rather than to each individual financial instrument included in that position) only if the market risks that are being offset are substantially the same. Some respondents to the FASB's proposed ASU asked for additional guidance on what is meant by *substantially the same* given the different instruments and types of instruments that might make up a portfolio. In addition, they were concerned that the proposed requirement that the market risks be substantially the same meant that there could be no basis risk in the portfolio or, conversely, that the basis risk would not be reflected in the fair value measurement.
- BC123 Consequently, the boards decided to include additional guidance for determining whether market risks are substantially the same. The boards held discussions with several financial institutions that manage their financial assets and financial liabilities on the basis of their net exposure to market risks. From those discussions, the boards concluded that when measuring fair value on the basis of an entity's net exposure to market risks, the entity should not combine a financial asset that exposes it to a particular market risk with a financial liability that exposes it to a different market risk that does not mitigate either of the market risk exposures that the entity faces. The boards also concluded that it is not necessary that the grouping of particular financial assets and financial liabilities results in an entity having no basis risk because the fair value measurement would take into account any basis risk. Furthermore, on the basis of their discussions with financial institutions, the boards concluded that an entity should not combine a financial asset that exposes it to a particular market risk over a particular duration with a financial liability that exposes it to substantially the same market risk over a different duration without taking into account the fact that the entity is fully exposed to that market risk over the time period for which the market risks are not offset. If there is a time period in which a market risk is not offset, the entity may measure its net exposure to that market risk over the time period in which the market risk is offset and must measure its gross exposure to that market risk for the remaining time period (ie the time period in which the market risk is not offset).

*Exposure to the credit risk of a particular counterparty*

- BC124 Because the bid-ask spread (which is the basis for making adjustments for an entity's exposure to market risk to arrive at the fair value of the net position) does not include adjustments for counterparty credit risk (see paragraph BC164), the boards decided to specify that an entity may take into account its net exposure to the credit risk of a particular counterparty when applying the exception.
- BC125 The boards decided that when measuring fair value, an entity may consider its net exposure to credit risk when it has entered into an arrangement with a counterparty that mitigates its credit risk exposure in the event of default (eg a master netting agreement). On the basis of their discussions with financial institutions the boards concluded that a fair value measurement reflects market participants' expectations about the likelihood that such an arrangement would be legally enforceable.
- BC126 Some respondents to the FASB's proposed ASU asked whether the existence of a master netting agreement was necessary or whether other credit mitigating arrangements could be taken into account in the fair value measurement. The boards decided to clarify that in a fair value measurement, an entity must take into account other arrangements that mitigate credit risk, such as an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party, if market participants would expect such arrangements to be legally enforceable in the event of default.
- BC127 The boards acknowledged that the group of financial assets and financial liabilities for which an entity manages its net exposure to a particular market risk (or risks) could differ from the group of financial assets and financial liabilities for which an entity manages its net exposure to the credit risk of a particular counterparty because it is unlikely that all contracts would be with the same counterparty.

*Relationship between measurement and presentation*

- BC128 In some cases the basis for the presentation of financial instruments in the statement of financial position differs from the basis for the measurement of those financial instruments. For example, that would be the case if an IFRS does not require or permit financial instruments to be presented on a net basis. The FASB's proposed ASU stated that the exception would not apply to financial statement presentation (ie an entity must comply with the financial statement presentation requirements specified in other standards).
- BC129 The boards discussed the different approaches to measurement and presentation, particularly in the light of their currently differing requirements for offsetting financial assets and financial liabilities. In IAS 32 an entity may not use net presentation unless specific criteria are met, whereas in US GAAP many entities are able to use net presentation in their financial statements. However, the criteria for net presentation in US GAAP relate to credit risk, not to market risks. As a result, the presentation and measurement bases are different when an entity applies bid-ask adjustments on a net basis but is required to present fair value information on a gross basis (although generally the financial instruments with bid-ask adjustments would

qualify for net presentation in US GAAP because of the existence of master netting agreements and other credit risk mitigating arrangements).

- BC130 The boards concluded that a relationship between presentation and measurement is not necessary and that adjustments for market risks or credit risk (ie portfolio-level adjustments) are a matter of measurement rather than presentation. They reasoned that fair value measurements are meant to reflect (a) the risk exposure faced by the entity and (b) how that risk exposure would be priced by market participants (which is one reason the boards decided to permit the exception; see paragraph BC117). When pricing financial instruments, a market participant would take into account the other instruments it holds to the extent that those instruments reduce or enhance its overall risk exposure. That is a consequence of requiring or permitting financial instruments to be measured at fair value. The boards' considerations for requiring net or gross presentation of financial instruments are different from those for requiring net or gross measurement.
- BC131 Some respondents asked for additional guidance for allocating the bid-ask and credit adjustments to the individual assets and liabilities that make up the group of financial assets and financial liabilities. Although any allocation method is inherently subjective, the boards concluded that a quantitative allocation would be appropriate if it was reasonable and consistently applied. Therefore, the boards decided not to require a particular method of allocation.

## Fair value at initial recognition

- BC132 The exposure draft proposed guidance for measuring fair value at initial recognition, using both observable and unobservable inputs (as appropriate). The exposure draft also proposed a list of indicators specifying when the transaction price might not be the best evidence of the fair value of an asset or a liability at initial recognition.
- BC133 Respondents generally agreed with the list of indicators, but thought that the wording used implied that those were the only indicators, rather than examples of indicators. They suggested that the IFRS on fair value measurement should use the wording in US GAAP. The boards agreed with respondents that the list of indicators was not exhaustive and decided to use the wording in Topic 820.
- BC134 Some respondents suggested that market inactivity should be included in the list of indicators. The boards concluded that market inactivity is not an indicator that the transaction price may not represent fair value, but an indicator that the entity should do further work to determine whether the transaction price represents fair value.
- BC135 The exposure draft did not address the recognition of a day 1 gain or loss but stated that an entity would recognise such gains or losses unless another IFRS specifies otherwise. For example, IAS 39 and IFRS 9 state that an entity cannot recognise a day 1 gain or loss for a financial instrument unless its fair value is evidenced by a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only data from observable markets. In contrast, IFRS 3 and IAS 41 require the recognition of day 1 gains or losses even when fair value is measured using unobservable inputs.
- BC136 The IASB concluded that fair value should be measured at initial recognition without regard to whether it would result in a gain or loss at initial recognition of the asset or liability. Respondents' views ranged from the view that the transaction price is the best evidence of fair value at initial recognition unless the fair value is measured using only observable inputs (the approach in IAS 39 and IFRS 9) to the view that the transaction price might sometimes, but not always, represent fair value at initial recognition, and that the degree of observability of inputs is not always the best indicator of whether this is the case (the approach in US GAAP).
- BC137 Many respondents suggested that IFRSs and US GAAP should have the same requirements for recognising gains or losses at initial recognition. The boards concluded that determining whether to recognise a day 1 gain or loss was beyond the scope of the fair value measurement project. The boards noted that the measurement basis at initial recognition of financial instruments in IFRSs and US GAAP is not always the same, and so the boards could not address comparability at this time. As a result, the boards decided that an entity would refer to relevant IFRSs for the asset or liability when determining whether to recognise those amounts. The boards concluded that if the relevant IFRS does not specify whether and, if so, where to recognise those amounts, the entity should recognise them in profit or loss.
- BC138 Although the IASB did not change the recognition threshold, it amended IAS 39 and IFRS 9 to clarify that the fair value of financial instruments at initial recognition should be measured in accordance with IFRS 13 and that any deferred amounts arising from the application of the recognition threshold in IAS 39 and IFRS 9 are separate from the fair value measurement. In other words, the recognition threshold in IAS 39 and IFRS 9 is not a constraint when measuring fair value. Rather, it determines whether (and when) the resulting difference (if any) between fair value at initial recognition and the transaction price is recognised.

## Valuation techniques

- BC139 When measuring fair value, the objective of using a valuation technique is to estimate the price at which an orderly transaction would take place between market participants at the measurement date under current market conditions.
- BC140 To meet that objective, the exposure draft proposed that valuation techniques used to measure fair value should be consistent with the market approach, income approach or cost approach. Such valuation techniques are consistent with those already described in IFRSs and with valuation practice.
- BC141 Respondents generally agreed with the descriptions of the three valuation techniques. Some respondents questioned whether a cost approach is consistent with an exit price definition of fair value because they think that the cost to replace an asset is more consistent with an entry price than an exit price. The IASB noted that an entity's cost to replace an asset would equal the amount that a market participant buyer of that asset (that would use it similarly) would pay to acquire it (ie the entry price and the exit price would be equal in the same market). Thus, the IASB concluded that the cost approach is consistent with an exit price definition of fair value.

## Single versus multiple valuation techniques

- BC142 IFRS 13 does not contain a hierarchy of valuation techniques because particular valuation techniques might be more appropriate in some circumstances than in others. The IASB concluded that determining the appropriateness of valuation techniques in the circumstances requires judgement and noted that Topic 820 and the fair value measurement guidance already in IFRSs do not contain a hierarchy of valuation techniques. For example, IAS 41 acknowledged that in some cases the various approaches used by an entity might suggest different fair value conclusions for a biological asset or agricultural produce, but that the entity should consider the reasons for the differences to arrive at a fair value within a reasonable range.

## Valuation adjustments

- BC143 Some respondents asked for more explicit requirements about applying valuation adjustments (including risk adjustments related to the uncertainty inherent in the inputs used in a fair value measurement; see paragraphs BC149 and BC150). They found the descriptions of valuation adjustments in the IASB's Fair Value Expert Advisory Panel's October 2008 report *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* helpful (see paragraph BC177). In addition, regulators asked the IASB to address measurement uncertainty to ensure that fair value measurements are not overstated or understated in the statement of financial position, thus improving the quality of information available to users of financial statements.
- BC144 Although the exposure draft was not explicit with respect to valuation adjustments, it stated that an entity must use the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique or in the inputs to the valuation technique. That implicitly included measurement uncertainty.
- BC145 The boards noted that entities found the IASB's Fair Value Expert Advisory Panel's report helpful when measuring the fair value of financial instruments during a period of market inactivity. As a result, the boards decided to describe the valuation adjustments that entities might need to make when using a valuation technique because market participants would make those adjustments when pricing a financial asset or financial liability under the market conditions at the measurement date, including adjustments for measurement uncertainty. Those valuation adjustments include the following:
- (a) an adjustment to a valuation technique to take into account a characteristic of an asset or a liability that is not captured by the valuation technique (the need for such an adjustment is typically identified during calibration of the value calculated using the valuation technique with observable market information).
  - (b) applying the point within the bid-ask spread that is most representative of fair value in the circumstances.
  - (c) an adjustment to take into account non-performance risk (eg an entity's own credit risk or the credit risk of the counterparty to a transaction).
  - (d) an adjustment to take into account measurement uncertainty (eg when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value).

- BC146 The boards decided that it would be appropriate to apply such valuation adjustments if those adjustments are consistent with the objective of a fair value measurement. Valuation adjustments may help avoid an understatement or overstatement of a fair value measurement and should be applied when a valuation technique or the inputs to a valuation technique do not capture factors that market participants would take into account when pricing an asset or a liability at the measurement date, including assumptions about risk.

### Consistency constraint

- BC147 IFRS 13 emphasises the need for consistency in the valuation technique or techniques used to measure fair value. It does not preclude a change in valuation technique, provided that the change results in a measurement that is equally or more representative of fair value in the circumstances. The exposure draft proposed requiring an entity to disclose the effect of a change in valuation technique on a fair value measurement (similar to the disclosures required by IAS 8 for a change in valuation technique). Respondents did not support that proposal because they thought it would be difficult to determine whether a change in fair value was attributable to a change in the valuation technique used or attributable to changes in other factors (such as changes in the observability of the inputs used in the measurement).
- BC148 The IASB agreed with those respondents and decided that in the absence of an error (eg in the selection or application of a particular valuation technique), revisions resulting from a change in the valuation technique or its application should be accounted for as a change in accounting estimate in accordance with IAS 8. The IASB concluded that disclosing the effect of a change in valuation technique on the fair value measurement or requiring the disclosures in IAS 8 for a change in accounting estimate would not be cost-beneficial.

## Inputs to valuation techniques

### Assumptions about risk

- BC149 In IFRS 13 inputs refer broadly to the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. The IASB decided that a necessary input to a valuation technique is an adjustment for risk because market participants would make such an adjustment when pricing an asset or a liability. Therefore, including an adjustment for risk ensures that the measurement reflects an exit price for the asset or liability, ie the price that would be received in an orderly transaction to sell an asset or paid in an orderly transaction to transfer the liability at the measurement date under current market conditions.
- BC150 The IASB accepted that it might be difficult for an entity to quantify a risk adjustment in some cases, but concluded that this difficulty does not justify the exclusion of this input if market participants would take it into account. The exposure draft focused on the need to adjust for the risk inherent in a particular valuation technique used to measure fair value, such as a pricing model (model risk) and the risk inherent in the inputs to the valuation technique (input risk). That proposal was consistent with US GAAP.

### Observable and unobservable inputs

- BC151 IFRS 13 distinguishes between observable inputs and unobservable inputs, and requires an entity to maximise the use of relevant observable inputs and minimise the use of unobservable inputs (consistently with the fair value measurement guidance that was already in IFRSs). Respondents to the exposure draft expressed concerns about being required to use observable inputs during the global financial crisis that started in 2007 when the available observable inputs were not representative of the asset or liability being measured at fair value. Given that feedback, the IASB wanted to ensure that observability was not the only criterion applied when selecting the inputs to a valuation technique. Consequently, IFRS 13 focuses on *relevant* observable inputs because the IASB noted that in some cases the available observable inputs will require an entity to make significant adjustments to them given the characteristics of the asset or liability and the circumstances at the measurement date (eg market conditions).

### Application of premiums and discounts in a fair value measurement

- BC152 The exposure draft proposed an amendment to IAS 39 making it explicit that the unit of account for a financial instrument is the individual financial instrument at all levels of the fair value hierarchy. That proposal in effect would have prohibited the application of premiums and discounts related to the size of an entity's holding in a fair value measurement categorised within any level of the fair value hierarchy for financial instruments within the scope of IAS 39. The IASB proposed that amendment for the following reasons:
- (a) The unit of account for a financial instrument should not depend on an instrument's categorisation within the fair value hierarchy.

- (b) Market participants will enter into a transaction to sell a financial instrument that maximises the fair value of an asset or minimises the fair value of a liability. An entity's decision to sell at a less advantageous price because it sells an entire holding rather than each instrument individually is a factor specific to that reporting entity.
- BC153 Before the amendments to Topic 820, US GAAP generally prohibited any adjustment to a quoted price in an active market for an identical asset or liability for a fair value measurement categorised within Level 1 of the fair value hierarchy (including either a blockage factor, which was described as an adjustment to a quoted price for an asset or a liability when the normal daily trading volume for the asset or liability is not sufficient to absorb the quantity held and therefore placing orders to sell the asset or liability in a single transaction might affect the quoted price, or any other premium or discount). However, Topic 820 did not specify whether a blockage factor (or another premium or discount, such as a control premium or a non-controlling interest discount) should be applied in a fair value measurement categorised within Level 2 or Level 3 of the fair value hierarchy if market participants would take it into account when pricing the asset or liability.
- BC154 Respondents interpreted the proposal in the exposure draft as being consistent with Topic 820 for fair value measurements categorised within Level 1 of the fair value hierarchy, but they thought it was inconsistent with Topic 820 for fair value measurements categorised within Level 2 and Level 3. For example, some respondents thought that the IASB intended to prohibit the application of any premiums or discounts (such as a control premium) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy even when market participants would take into account a premium or discount when pricing the asset or liability for a particular unit of account.
- BC155 Some respondents supported the proposal for fair value measurements categorised within Level 1 of the fair value hierarchy even though, in their view, entities do not typically exit a position on an individual instrument basis (eg by entering into a transaction to sell a single share of equity). Those respondents understood the boards' concerns about verifiability within Level 1. Other respondents stated that the fair value measurement should reflect the fair value of the entity's *holding*, not of each individual instrument within that holding (ie they did not agree that the unit of account for a financial instrument should be a single instrument). Those respondents maintained that the principle should be that the unit of account reflects how market participants would enter into a transaction for the asset or liability. They asserted that market participants would not (and often cannot) sell individual items. The FASB received similar comments when developing SFAS 157. The boards concluded that such concerns were outside the scope of the fair value measurement project because the project addressed *how* to measure fair value and not *what* is measured at fair value.
- BC156 In addition, the comments received on the exposure draft indicated that respondents had different interpretations of the term *blockage factor*. Many respondents interpreted a blockage factor as any adjustment made because of the size of an asset or a liability. In the boards' view, there is a difference between size being a characteristic of the asset or liability and size being a characteristic of the entity's holding. Accordingly, the boards clarified that a blockage factor encompasses the latter and is not relevant in a fair value measurement because a fair value measurement reflects the value of the asset or liability to a market participant for a particular unit of account and is not necessarily representative of the value of the entity's entire holding.
- BC157 Given the description of a blockage factor, the boards concluded that an entity's decision to realise a blockage factor is specific to that entity, not to the asset or liability. In many cases the unit of account for a financial instrument for financial reporting is the individual financial instrument. In such cases the size of an entity's holding is not relevant in a fair value measurement. An entity would realise a blockage factor when that entity decides to enter into a transaction to sell a block consisting of a large number of identical assets or liabilities. Therefore, blockage factors are conceptually similar to transaction costs in that they will differ depending on how an entity enters into a transaction for an asset or a liability. The boards concluded that if an entity decides to enter into a transaction to sell a block, the consequences of that decision should be recognised when the decision is carried out regardless of the level of the fair value hierarchy in which the fair value measurement is categorised.
- BC158 Therefore, the boards decided to clarify that the application of premiums and discounts in a fair value measurement is related to the characteristics of the asset or liability being measured at fair value and its unit of account. IFRS 13 specifies that when a Level 1 input is not available, a fair value measurement should incorporate premiums or discounts if market participants would take them into account in a transaction for the asset or liability. Paragraph BC168 describes the IASB's rationale for requiring an entity to use Level 1 inputs without adjustment whenever available. However, the boards decided to clarify that the application of premiums or discounts must be consistent with the unit of account in the IFRS that requires or permits the fair value measurement.
- BC159 The boards decided not to provide detailed descriptions of premiums and discounts or to provide detailed guidance about their application in a fair value measurement. They reasoned that such descriptions and guidance would be too prescriptive because the application of premiums and discounts in a fair value

measurement depends on the facts and circumstances at the measurement date. In the boards' view, different facts and circumstances might lead to particular premiums or discounts being relevant for some assets and liabilities but not for others (eg in different jurisdictions). Furthermore, the boards did not intend to preclude the use of particular premiums or discounts, except for blockage factors.

### Inputs based on bid and ask prices

- BC160 In some situations, inputs might be determined on the basis of bid and ask prices, eg an input from a dealer market, in which the bid price represents the price the dealer is willing to pay and the ask price represents the price at which the dealer is willing to sell. IAS 39 required the use of bid prices for asset positions and ask prices for liability positions. IAS 36 and IAS 38 *Intangible Assets* had similar requirements.
- BC161 The exposure draft proposed that a fair value measurement should use the price within the bid-ask spread that is most representative of fair value in the circumstances. Furthermore, the exposure draft stated that the bid-ask spread guidance applied at all levels of the fair value hierarchy, when bid and ask prices are relevant (see paragraph BC165), and did not preclude the use of mid-market pricing or other pricing conventions that are used by market participants as a practical expedient.
- BC162 Many respondents supported the proposal because in their experience different market participants enter into transactions at different prices within a bid-ask spread. Some respondents preferred a single bid-ask spread pricing method, as described in IAS 39, because it would maximise the consistency and comparability of fair value measurements using bid and ask prices.
- BC163 The IASB observed that, in many situations, bid and ask prices establish the boundaries within which market participants would negotiate the price in the exchange for the asset or liability. Having clarified the fair value measurement objective, the IASB concluded that an entity should use judgement in meeting that objective. Accordingly, IFRS 13 states that a fair value measurement should use the price within the bid-ask spread that is most representative of fair value in the circumstances, and that the use of bid prices for asset positions and ask prices for liability positions is permitted but is not required.
- BC164 IAS 39 stated that the *bid-ask spread* includes only transaction costs. In IAS 39 other adjustments to arrive at fair value (eg for counterparty credit risk) were not included in the term *bid-ask spread*. Some respondents asked whether the proposed bid-ask guidance reflected that view. Although the boards decided not to specify what, if anything, is in a bid-ask spread besides transaction costs, in the boards' view the bid-ask spread does not include adjustments for counterparty credit risk (see paragraphs BC124–BC127 for a discussion on adjustments for counterparty credit risk when measuring fair value). Therefore, an entity will need to make an assessment of what is in the bid-ask spread for an asset or a liability when determining the point within the bid-ask spread that is most representative of fair value in the circumstances.
- BC165 Some respondents noted that there could be a difference between entry prices and exit prices when entities enter into transactions at different points within the bid-ask spread. For example, an entity might buy an asset at the ask price (entry price) and measure fair value using the bid price (exit price). The boards concluded that bid-ask spreads are only relevant for financial instruments and in markets in which an intermediary (eg a broker) is necessary to bring together a buyer and a seller to engage in a transaction (ie when the buyer and seller need an intermediary to find one another). When measuring the fair value of a non-financial asset or non-financial liability, the notion of a bid-ask spread will not be relevant because the buyers and sellers in the principal (or most advantageous) market have already found one another and are assumed to have negotiated the transaction price (ie fair value).

### Fair value hierarchy

- BC166 IFRS 13 uses a three-level fair value hierarchy, as follows:
- (a) Level 1 comprises unadjusted quoted prices in active markets for identical assets and liabilities.
  - (b) Level 2 comprises other observable inputs not included within Level 1 of the fair value hierarchy.
  - (c) Level 3 comprises unobservable inputs (including the entity's own data, which are adjusted if necessary to reflect the assumptions market participants would use in the circumstances).
- BC167 The IASB noted that many IFRSs already contained an implicit fair value hierarchy by referring to observable market transactions or measuring fair value using a valuation technique. For example, the following three-level measurement hierarchy was implicit in IAS 39 and IFRS 9:
- (a) financial instruments quoted in an active market;

- (b) financial instruments whose fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets; and
- (c) financial instruments whose fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (ie without modification or repackaging) and not based on available observable market data.

### Level 1 inputs

- BC168 Level 1 inputs are unadjusted quoted prices in active markets for identical assets and liabilities. The IASB concluded that those prices generally provide the most reliable evidence of fair value and should be used to measure fair value whenever available.
- BC169 IFRS 13 defines an active market as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. The IASB concluded that although different words are used, that definition is consistent with the definitions of an active market already in IFRSs:
- (a) IASs 36, 38 and 41 stated that an active market is one in which ‘(i) the items traded in the market are homogeneous; (ii) willing buyers and sellers can normally be found at any time; and (iii) prices are available to the public.’
  - (b) IAS 39 and IFRS 9 stated that an active market is one in which ‘quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm’s length basis.’
- BC170 IFRS 13 states that when an entity holds a large number of similar assets and liabilities that are required to be measured at fair value and a quoted price in an active market is not readily accessible for each of those assets and liabilities, the entity can use an alternative pricing method that does not rely exclusively on quoted prices as a practical expedient (although the resulting fair value measurement is a lower level measurement). For example, an entity might hold a large number of similar debt instruments (such as sovereign debt securities) and use matrix pricing, which does not rely exclusively on quoted prices, to measure the fair value of those instruments. In such a situation, although a Level 1 input is used to measure fair value, the fair value measurement would not be categorised within Level 1 of the fair value hierarchy. That is a departure from the principle that a fair value measurement should maximise the use of relevant observable inputs. However, the IASB regards this particular practical expedient as justified on cost-benefit grounds.

### Level 2 inputs

- BC171 Level 2 inputs are all inputs other than quoted prices included in Level 1 that are observable (either directly or indirectly) for the asset or liability. The IASB concluded that it is appropriate to include in Level 2 market-corroborated inputs that might not be directly observable, but are based on or supported by observable market data, because such inputs are less subjective than unobservable inputs classified within Level 3.

### Level 3 inputs

- BC172 Level 3 inputs are unobservable inputs for the asset or liability.
- BC173 Some respondents stated that it would be misleading to describe a measurement using significant unobservable inputs as a fair value measurement. They also expressed concerns that unobservable inputs may include entity-specific factors that market participants would not consider. Therefore, they suggested that the IASB should use a different label for measurements that use significant unobservable inputs. However, the IASB concluded that it would be more helpful to users of financial statements to use the label *fair value* for all three levels of the hierarchy described in the exposure draft, for the following reasons:
- (a) The proposed definition of fair value identifies a clear objective for valuation techniques and the inputs to them: consider all factors that market participants would consider and exclude all factors that market participants would exclude. An alternative label for Level 3 measurements would be unlikely to identify such a clear objective.
  - (b) The distinction between Levels 2 and 3 is inevitably subjective. It is undesirable to adopt different measurement objectives on either side of such a subjective boundary.

Rather than requiring a different label for measurements derived using significant unobservable inputs, the IASB concluded that concerns about the subjectivity of those measurements are best addressed by requiring

enhanced disclosure for those measurements (see paragraphs BC187–BC210).

- BC174 The IASB accepts that the starting point for Level 3 inputs might be estimates developed by the entity. However, the entity must adjust those inputs if reasonably available information indicates that other market participants would use different data when pricing the asset or liability or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy).
- BC175 Some respondents expressed concerns that an entity would be compelled by its auditors or regulators to undertake exhaustive efforts to obtain information about the assumptions that market participants would use when pricing the asset or liability. Furthermore, they were concerned that their judgement would be questioned when asserting the absence of contrary data. IFRS 13 states that such exhaustive efforts would not be necessary. However, when information about market participant assumptions is reasonably available, an entity cannot ignore it.

### **Measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased**

- BC176 The global financial crisis that started in 2007 emphasised the importance of having common fair value measurement requirements in IFRSs and US GAAP, particularly for measuring fair value when the market activity for an asset or a liability declines. As a result, and consistently with the recommendations of the Group of Twenty (G20) Leaders, the Financial Stability Board and the IASB's and FASB's Financial Crisis Advisory Group, the IASB and the FASB worked together to develop common requirements for measuring the fair value of assets and liabilities when markets are no longer active.
- BC177 In May 2008 the IASB set up a Fair Value Expert Advisory Panel in response to recommendations made by the Financial Stability Forum (now the Financial Stability Board) to address the measurement and disclosure of financial instruments when markets are no longer active. The Panel's discussions were observed by FASB staff. In October 2008 the IASB staff published a staff report on the Panel's discussions.
- BC178 Also in response to the global financial crisis, in April 2009 the FASB issued FASB Staff Position (FSP) No. FAS 157-4 *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. That FSP was codified in Topic 820 and provides guidance for:
- (a) measuring fair value when the volume or level of activity for the asset or liability has significantly decreased; and
  - (b) identifying circumstances that indicate a transaction is not orderly.
- BC179 IASB published a Request for Views that asked respondents whether they believed that the guidance in that FSP was consistent with the Panel's report. The IASB also asked members of the Fair Value Expert Advisory Panel the same question. The IASB received 69 responses to the Request for Views. The respondents to the Request for Views and the members of the Fair Value Expert Advisory Panel indicated that the FSP was consistent with the Panel's report. As a result, the IASB included the guidance from FSP FAS 157-4 in the exposure draft.
- BC180 Respondents to the exposure draft generally agreed with the proposed guidance and found it consistent with the concepts in the IASB's Fair Value Expert Advisory Panel's report and in US GAAP. However, some respondents noted that the words used in the exposure draft were different from those used in US GAAP and wondered whether the requirements were meant to be different. The boards acknowledged those concerns and decided to align the wording. In addition, the boards decided to clarify that the requirements pertain to when there has been a significant decline in the volume or level of activity for the asset or liability, not to assets and liabilities for which there is typically no observable market.
- BC181 Furthermore, the boards concluded that when applying IFRS 13 and Topic 820 an entity should focus on whether an observed transaction price is the result of an orderly transaction, not only on the level of activity in a market, because even in a market with little activity, transactions can be orderly. Accordingly, the boards concluded that an entity should consider observable transaction prices unless there is evidence that the transaction is not orderly. If an entity does not have sufficient information to determine whether a transaction is orderly, it performs further analysis to measure fair value.
- BC182 Also as a result of the global financial crisis, there was a particularly urgent need to improve transparency of fair value measurements for financial instruments. To address that need, the IASB amended IFRS 7 *Financial Instruments: Disclosures* in March 2009. The amended disclosures about fair value measurements have been relocated to IFRS 13.

## Disclosure

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- BC183 The disclosures about fair value measurements in IFRSs vary, although many require, at a minimum, information about the methods and significant assumptions used in the measurement, and whether fair value was measured using observable prices from recent market transactions for the same or a similar asset or liability.
- BC184 The IASB decided that having established a framework for measuring fair value, it should also enhance and harmonise the disclosures about fair value measurements. The IASB decided to limit the disclosures to fair values measured in the statement of financial position after initial recognition, whether those measurements are made on a recurring or non-recurring basis, because other IFRSs address the disclosure of fair values at initial recognition (eg IFRS 3 requires disclosure of the measurement of assets acquired and liabilities assumed in a business combination).
- BC185 The objective of the disclosures in IFRS 13 is to provide users of financial statements with information about the valuation techniques and inputs used to develop fair value measurements and how fair value measurements using significant unobservable inputs affected profit or loss or other comprehensive income for the period. To meet those objectives, the disclosure framework (a) combines the disclosures currently required by IFRSs and US GAAP and (b) provides additional disclosures that users of financial statements suggested would be helpful in their analyses. In developing the disclosures, the IASB used information received from users and preparers of financial statements and the IASB's Fair Value Expert Advisory Panel.

### Distinguishing between recurring and non-recurring fair value measurements

- BC186 The disclosures in US GAAP differentiate fair value measurements that are recurring from those that are non-recurring. The exposure draft did not propose differentiating recurring from non-recurring fair value measurements and required the same information about all fair value measurements. However, users of financial statements asked the IASB to include the same principles for disclosing information about fair value measurements in IFRSs that are in US GAAP. As a result, the boards decided to differentiate the two types of fair value measurements and to describe their differences.

### Information about fair value measurements categorised within Level 3 of the fair value hierarchy

- BC187 The boards received requests from users of financial statements for more information about fair value measurements categorised within Level 3 of the fair value hierarchy. The following sections describe the boards' response to those requests.

#### Quantitative information

- BC188 The exposure draft proposed requiring an entity to disclose the methods and inputs used in a fair value measurement, including the information used to develop those inputs. That proposal was developed using feedback from users of financial statements and the IASB's Fair Value Expert Advisory Panel. Although the proposal was not explicit, the IASB intended that the information about the inputs used in the measurement would be quantitative.
- BC189 Before the amendments to Topic 820, US GAAP required an entity to provide a description of the inputs used when measuring the fair value of an asset or a liability that is categorised within Level 2 or Level 3 of the fair value hierarchy. Topic 820 was not explicit about whether that description needed to include quantitative information.
- BC190 Users of financial statements asked the boards to clarify that entities must provide quantitative information about the inputs used in a fair value measurement, particularly information about unobservable inputs used in a measurement categorised within Level 3 of the fair value hierarchy. When limited or no information is publicly available, disclosures about such information help users to understand the measurement uncertainty inherent in the fair value measurement.
- BC191 Therefore, the boards decided to clarify that an entity should disclose *quantitative* information about the significant unobservable inputs used in a fair value measurement categorised within Level 3 of the fair value hierarchy.
- BC192 Some respondents to the FASB's proposed ASU questioned the usefulness of quantitative information about the unobservable inputs used in a fair value measurement because of the level of aggregation required in

those disclosures. The boards noted that the objective of the disclosure is not to enable users of financial statements to replicate the entity's pricing models, but to provide enough information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions. The boards concluded that the information required by the disclosure will facilitate comparison of the inputs used over time, providing users with information about changes in management's views about particular unobservable inputs and about changes in the market for the assets and liabilities within a particular class. In addition, that disclosure might facilitate comparison between entities with similar assets and liabilities categorised within Level 3 of the fair value hierarchy.

- BC193 IFRS 13 and Topic 820 state that an entity should determine appropriate classes of assets and liabilities on the basis of the nature, characteristics and risks of the assets and liabilities, noting that further disaggregation might be required for fair value measurements categorised within Level 3 of the fair value hierarchy. Consequently, the boards concluded that the meaningfulness of the disclosure of quantitative information used in Level 3 fair value measurements will depend on an entity's determination of its asset and liability classes.
- BC194 Some respondents to the IASB's re-exposure document and the FASB's proposed ASU suggested requiring quantitative information about the unobservable inputs used in fair value measurements categorised within Level 2 of the fair value hierarchy because determining whether to categorise fair value measurements within Level 2 or Level 3 can be subjective. The boards concluded that for a fair value measurement to be categorised within Level 2 of the fair value hierarchy, the unobservable inputs used, if any, must not be significant to the measurement in its entirety. As a result, the boards decided that quantitative information about unobservable inputs would be of limited use for those measurements.
- BC195 In addition, the boards understand that fair value is sometimes measured on the basis of prices in prior transactions (eg adjustments to the last round of financing for a venture capital investment) or third-party pricing information (eg broker quotes). Such measurements might be categorised within Level 3 of the fair value hierarchy. In such cases, the boards concluded that an entity should be required to disclose how it has measured the fair value of the asset or liability, but that it should not need to create quantitative information (eg an implied market multiple or future cash flows) to comply with the disclosure requirement if quantitative information other than the prior transaction price or third-party pricing information is not used when measuring fair value. However, the boards concluded that when using a prior transaction price or third-party pricing information, an entity cannot ignore other quantitative information that is reasonably available. If there was an adjustment to the price in a prior transaction or third-party pricing information that is significant to the fair value measurement in its entirety, that adjustment would be an unobservable input about which the entity would disclose quantitative information even if the entity does not disclose the unobservable information used when pricing the prior transaction or developing the third-party pricing information.

### Level 3 reconciliation for recurring fair value measurements

- BC196 The exposure draft proposed requiring an entity to provide a reconciliation from the opening balances to the closing balances of fair value measurements categorised within Level 3 of the fair value hierarchy. IFRS 7 required such a disclosure for financial instruments after it was amended in March 2009 to introduce a three-level fair value hierarchy, and to require more detailed information about fair value measurements categorised within Level 3 of the fair value hierarchy. In addition, many IFRSs already required a similar reconciliation for all fair value measurements, not only for those that are categorised within Level 3 of the fair value hierarchy.
- BC197 Some respondents agreed with the proposed reconciliation disclosure because they thought it would help meet the objective to provide meaningful information to users of financial statements about the relative subjectivity of fair value measurements. Other respondents thought that the disclosure requirement would be onerous and did not believe that the benefits would outweigh the costs, particularly for non-financial assets and liabilities. The IASB received similar feedback on the proposed amendments to IFRS 7. However, users of financial statements told the IASB that the disclosures made in accordance with US GAAP and IFRS 7 were helpful, particularly in the light of the global financial crisis that started in 2007. They indicated that the disclosures allowed them to make more informed judgements and to segregate the effects of fair value measurements that are inherently subjective, thereby enhancing their ability to assess the quality of an entity's reported earnings. Consequently, the IASB decided to require an entity to provide such a reconciliation.
- BC198 The exposure draft and IFRS 7 did not distinguish between *realised* and *unrealised* gains or losses. That was because those documents referred to *gains or losses attributable to assets and liabilities held at the end of the reporting period*, which the IASB meant to be equivalent to *unrealised* gains or losses (ie realised gains or losses result from the sale, disposal or settlement of an asset or a liability, and therefore the asset or

liability is no longer held by the entity at the reporting date, whereas unrealised gains or losses relate to changes in the fair value of an asset or a liability that is held by the entity at the reporting date). Respondents to the exposure draft wondered whether the different terminology used in the exposure draft and in Topic 820 meant that the disclosure proposed for IFRSs would be different from the disclosure required by US GAAP. To ensure that there would be no differences in interpretation of the requirements in IFRSs and US GAAP, the IASB decided to use the terms *realised* and *unrealised* in the reconciliation disclosure.

- BC199 The IASB concluded that the disclosure should focus on recurring fair value measurements because it would be difficult to reconcile the opening balances to the closing balances for non-recurring fair value measurements when the carrying amount of an asset or a liability is not determined on the basis of fair value at each reporting period. For example, it would be difficult to reconcile changes in fair value when an asset held for sale is recognised at its carrying amount in accordance with IFRS 5 in one period and at fair value less costs to sell in the next period. The information gained from requiring a reconciliation of changes in fair value from one period to the next is not available when requiring changes resulting from the use of different measurement bases from one period to the next.

### Valuation processes

- BC200 The boards decided to require an entity to disclose the valuation processes used for fair value measurements categorised within Level 3 of the fair value hierarchy (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period). They made that decision because users of financial statements told the boards that information about an entity's valuation processes helps them assess the relative subjectivity of the entity's fair value measurements, particularly for those categorised within Level 3 of the fair value hierarchy.
- BC201 In addition, the requirements in IFRS 13 are consistent with the conclusions of the IASB's Fair Value Expert Advisory Panel as described in its report in October 2008.

### Sensitivity to changes in unobservable inputs

- BC202 The exposure draft proposed requiring a quantitative sensitivity analysis for fair value measurements categorised within Level 3 of the fair value hierarchy. That proposal was taken from the requirement in IFRS 7 to disclose a sensitivity analysis if changing any of the unobservable inputs used in the measurement to reasonably possible alternative assumptions would change the fair value significantly. Although in IFRS 7 that disclosure was required for financial assets and financial liabilities measured at fair value, under the proposal it would have been required for all assets and liabilities measured at fair value.
- BC203 In August 2009 the FASB proposed a similar disclosure requirement in its proposed ASU *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, although that proposal would have required an entity to take into account the effect of interrelationships between inputs. Very few respondents to that proposed ASU supported the proposed disclosure, stating that it would not provide useful information and would be costly and operationally challenging. However, users were supportive of the proposed disclosure. The FASB decided to defer the consideration of a sensitivity analysis disclosure requirement to the joint fair value measurement project.
- BC204 In the boards' discussions about that sensitivity analysis disclosure, they considered whether the IASB's proposed disclosure and that in IFRS 7 would be improved if the boards required an entity to include the effect of interrelationships between unobservable inputs, thereby showing a range of fair values (exit prices) that reasonably could have been measured in the circumstances as of the measurement date. Because that refinement of the disclosure was not included in the IASB's May 2009 exposure draft and was not required by IFRS 7, the IASB needed to expose the proposal to require the sensitivity analysis including the effect of interrelationships between unobservable inputs. That disclosure was referred to in the IASB's re-exposure document and the FASB's proposed ASU in June 2010 as a *measurement uncertainty analysis disclosure*.
- BC205 Respondents to the FASB's proposed ASU and the IASB's re-exposure document were concerned about whether the proposal would be operational (those comments were consistent with those received on the FASB's proposed ASU in August 2009). Although that proposal was in response to requests from users of financial statements to require additional information about the measurement uncertainty inherent in fair value measurements (particularly those categorised within Level 3 of the fair value hierarchy), the responses from preparers of financial statements indicated that the costs associated with preparing such a disclosure would outweigh the benefits to users once the information had been aggregated by class of asset or liability. As an alternative to the proposal, those respondents suggested that the boards should require a qualitative assessment of the subjectivity of fair value measurements categorised within Level 3 of the fair value hierarchy, as well as an alternative quantitative approach that would be less costly to prepare (see paragraphs BC188–BC195).

- BC206 Therefore, the boards decided to require an entity to provide a narrative description, by class of asset or liability, of the sensitivity of a recurring fair value measurement categorised within Level 3 of the fair value hierarchy to changes in the unobservable inputs used in the measurement if a change in those inputs to a different amount would result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs, the boards decided to require an entity to provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. The boards concluded that such information would provide users of financial statements with information about how the selection of unobservable inputs affects the valuation of a particular class of assets or liabilities. The boards expect that the narrative description will focus on the unobservable inputs for which quantitative information is disclosed because those are the unobservable inputs that the entity has determined are most significant to the fair value measurement. They will continue to assess whether a quantitative measurement uncertainty analysis disclosure would be practical after issuing IFRS 13, with the aim of reaching a conclusion about whether to require such a disclosure at a later date.
- BC207 The boards concluded that a narrative description about sensitivity provides users of financial statements with information about the directional effect of a change in a significant unobservable input on a fair value measurement. That disclosure, coupled with quantitative information about the inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy, provides information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions. In addition, that disclosure provides information about the pricing model for those users who are not familiar with the valuation of a particular class of assets or liabilities (eg complex financial instruments).
- BC208 In addition to the narrative sensitivity analysis disclosure, IFRS 13 requires a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorised within Level 3 of the fair value hierarchy (ie the disclosure that was previously in IFRS 7). The IASB decided to move that requirement from IFRS 7 to IFRS 13 so that all the fair value measurement disclosure requirements in IFRSs are in a single location. When developing IFRS 7, the IASB concluded that information about the sensitivities of fair value measurements to the main valuation assumptions would provide users of financial statements with a sense of the potential variability of the measurement. In forming that conclusion, the IASB considered the view that disclosure of sensitivities could be difficult, particularly when there are many assumptions to which the disclosure would apply and those assumptions are interdependent. However, the IASB noted that a detailed quantitative disclosure of sensitivity to all assumptions is not required (only those that could result in a significantly different estimate of fair value are required) and that the disclosure does not require the entity to reflect interdependencies between assumptions when making the disclosure.
- BC209 The boards concluded that the objective of the narrative and quantitative sensitivity analysis disclosures about fair value are different from the objectives of other disclosures that an entity may be required to make in IFRSs and US GAAP, such as the market risk sensitivity analysis disclosure required by IFRS 7 (see paragraph 40 of IFRS 7). The IASB concluded that even though there is some overlap in those disclosures, the objective of each disclosure is different: the market risk sensitivity analysis disclosure in IFRS 7 provides information about an entity's exposure to future changes in market risks (ie currency risk, interest rate risk and other price risk), whereas the fair value measurement disclosures provide information about the sensitivity of the fair value measurement at the measurement date to changes in unobservable inputs for those fair value measurements with the greatest level of subjectivity (ie fair value measurements categorised within Level 3 of the fair value hierarchy). In addition, the market risk sensitivity analysis disclosure in IFRS 7 relates only to financial instruments (as does the quantitative sensitivity analysis disclosure in IFRS 13), whereas the narrative sensitivity analysis disclosure in IFRS 13 relates to all assets and liabilities measured at fair value.
- BC210 The IASB identified the following differences between the market risk and fair value sensitivity analysis disclosures:
- (a) The market risk disclosure is not specific to financial instruments measured at fair value, but also relates to financial instruments measured at amortised cost.
  - (b) The market risk disclosure focuses on the effect on profit or loss and equity, not specifically on the change in value.
  - (c) The market risk disclosure focuses only on the entity's exposure to market risks (ie interest rate risk, currency risk or other price risk), whereas the fair value disclosures take into account the effect on a fair value measurement of changes in significant unobservable inputs.
  - (d) The market risk disclosure does not distinguish between observable and unobservable inputs (or level in the fair value hierarchy, ie Level 1, 2 or 3), whereas the fair value disclosures relate only to the unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy.

## Transfers between Levels 1 and 2 of the fair value hierarchy

- BC211 The exposure draft proposed requiring an entity to disclose the amounts of *significant* transfers into or out of Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. That disclosure was also required in Topic 20. In their discussions, the boards decided instead to require a disclosure of *any* transfers into or out of Levels 1 and 2. Respondents to the FASB's proposed ASU generally did not support that proposal because it would require an entity to monitor all transfers on a daily basis, regardless of whether those transfers were significant. In addition, respondents were concerned about the accuracy of information about all transfers because there can be an unclear distinction between less active Level 1 fair value measurements and more active Level 2 fair value measurements.
- BC212 The boards concluded that the objective of the disclosure is to provide information that will help users of financial statements assess changes in market and trading activity (the entity's or others') so that users can (a) incorporate into their analyses the entity's future liquidity risk and (b) analyse the entity's exposure to the relative subjectivity of its fair value measurements. In the boards' view, the only way to provide that information, and to reduce the subjectivity involved in preparing the information, is to require information about *all* transfers between Level 1 and Level 2 of the fair value hierarchy.

## When an entity uses a non-financial asset in a way that differs from its highest and best use

- BC213 The boards decided to require an entity to disclose information about when it uses a non-financial asset in a way that differs from its highest and best use (when that asset is measured at fair value in the statement of financial position or when its fair value is disclosed). The boards concluded that such a disclosure provides useful information for users of financial statements that rely on fair value information when forecasting future cash flows, whether that fair value information is presented in the statement of financial position or is disclosed in the notes. Users told the boards that they would need to know how non-financial assets are being used and how that use fits with an entity's strategic and operating plans.
- BC214 The boards considered whether to limit the disclosure to some non-financial assets and not others. The boards concluded that because the measurement and disclosure requirements are principle-based, those requirements should not need to be amended in the future if the boards should decide to use fair value as the measurement basis for particular assets or liabilities. Therefore, the disclosure is required for any non-financial asset measured at fair value that an entity uses in a way that differs from its highest and best use.

## The categorisation within the level of the fair value hierarchy for items that are not measured at fair value in the statement of financial position

- BC215 IFRS 7 requires an entity to disclose the fair value of financial instruments even if they are not measured at fair value in the statement of financial position. An example is a financial instrument that is measured at amortised cost in the statement of financial position.
- BC216 The boards decided to require an entity to disclose the level of the fair value hierarchy in which an asset or a liability (financial or non-financial) would be categorised if that asset or liability had been measured at fair value in the statement of financial position. The boards concluded that such a disclosure would provide meaningful information about the relative subjectivity of that fair value measurement.
- BC217 Respondents to the IASB's exposure draft and the FASB's proposed ASU were concerned about the cost associated with preparing that disclosure because it is not always clear in which level a fair value measurement would be categorised. The boards concluded that even if determining the level in which to categorise a fair value measurement requires judgement, the benefits of doing so outweigh the costs. Therefore, the boards decided to require an entity to disclose the level of the fair value hierarchy in which an asset or a liability would be categorised if that asset or liability had been measured at fair value in the statement of financial position.

## Assets with a recoverable amount that is fair value less costs of disposal

- BC218 Because IAS 36 requires disclosures that are specific to impaired assets, the exposure draft did not propose requiring the disclosures about fair value measurements for assets with a recoverable amount that is fair

- value less costs of disposal in IAS 36. Some respondents (mainly users of financial statements) noted that the disclosures about impaired assets are different in IFRSs and in US GAAP (which requires assets to be tested for impairment by comparing their carrying amounts with their fair values) and asked the IASB to minimise those differences to ensure that users have access to similar information for their analyses of impaired assets.
- BC219 The IASB noted that the disclosure requirements in IAS 36 were developed specifically to ensure consistency in the disclosure of information about impaired assets so that the same type of information is provided whether the recoverable amount was determined on the basis of value in use or fair value less costs of disposal. Consequently, the IASB did not think it would be appropriate to require an entity to provide information when the recoverable amount is determined on the basis of fair value less costs of disposal (ie as required by IFRS 13) that is significantly different from what the entity would provide when the recoverable amount is determined on the basis of value in use.
- BC220 Although IFRSs and US GAAP have different impairment models, the IASB concluded that requiring the following information (in addition to what IAS 36 currently requires) about impaired assets measured at fair value less costs of disposal would improve comparability between entities applying IFRSs and those applying US GAAP as well as increase the convergence of IFRSs and US GAAP:
- the fair value less costs of disposal;
  - the level of the fair value hierarchy within which the fair value less costs of disposal is categorised in its entirety (Level 1, 2 or 3);
  - if applicable, changes to valuation techniques and reasons for those changes; and
  - quantitative information about significant inputs used when measuring fair value less costs of disposal (along with a conforming amendment to the disclosures about value in use).
- BC221 In addition, those disclosures are consistent with the disclosures required for non-recurring fair value measurements in IFRS 13 and in US GAAP.

## Interim financial reporting

- BC222 For financial instruments, the exposure draft proposed that particular fair value disclosures required in annual financial statements would also be required for interim financial reports. That differed from the approach proposed for non-financial assets and non-financial liabilities, for which there is no specific fair value disclosure requirement beyond the existing requirements in IAS 34 *Interim Financial Reporting*.
- BC223 Respondents generally thought that the principle underlying IAS 34 addresses when disclosures should be updated in interim financial reports. Some respondents thought the costs of providing updated information outweighed the benefits to users of financial statements of having that information.
- BC224 The IASB decided to include in IAS 34 an explicit requirement to provide updated disclosures because it concluded that the benefit of having incremental disclosures for financial instruments outweighed the associated costs given the increased interest in those instruments during the global financial crisis that started in 2007.

## Effective date and transition

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- BC225 When deciding the effective date for IFRS 13, the IASB considered the comments received on the Request for Views *Effective Date and Transition Methods*. Many respondents said that the effective date should allow enough time for them to put the necessary systems in place to ensure that their accounting policies and models meet the requirements of IFRS 13. Some of those respondents, particularly those with many assets and liabilities measured at fair value, requested a later effective date. Other respondents requested an earlier effective date, mainly for comparability reasons and because in their view many entities might have inadvertently already started applying the revised concepts.
- BC226 The IASB concluded that although IFRS 13 is a major new standard, it does not require any new fair value measurements and it does not fundamentally change many of the requirements for measuring fair value or for disclosing information about those measurements. The IASB concluded that in many respects, IFRS 13 uses different words to articulate the concepts already present in IFRSs. However, the IASB also considered the time that a particular country might require for translation and for introducing the mandatory requirements into law.
- BC227 Consequently, the IASB decided that IFRS 13 should be effective for annual periods beginning on or after 1 January 2013. Because IFRS 13 applies when other IFRSs require or permit fair value measurements (and does not introduce any new fair value measurements), the IASB believes that the extended transition period

- for IFRS 13 provides enough time for entities, their auditors and users of financial statements to prepare for implementation of its requirements.
- BC228 The IASB decided to permit early application of IFRS 13 because that would allow entities to apply the measurement and disclosure requirements as soon as practicable, thereby improving comparability in measurement and transparency in disclosures. That would also improve comparability with entities applying US GAAP.
- BC229 The exposure draft proposed prospective application because the IASB concluded that a change in the methods used to measure fair value would be inseparable from a change in the fair value measurements (ie as new events occur or as new information is obtained, eg through better insight or improved judgement). Respondents to the exposure draft and the Request for Views supported that proposal. Therefore, the IASB concluded that IFRS 13 should be applied prospectively (in the same way as a change in accounting estimate).
- BC230 To achieve comparability in future periods, the IASB decided to require the disclosures in IFRS 13 for the first interim period in which the IFRS is initially applied. However, those disclosures need not be presented in periods before initial application of the IFRS because it would be difficult to apply some of the requirements in IFRS 13 without the use of hindsight in selecting the inputs that would have been appropriate in prior periods.

## **Application in emerging and transition economies**

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- BC231 During the development of IFRS 13, the IASB received information from entities in emerging and transition economies that had concerns about applying the fair value measurement principles in IFRS 13 in their jurisdictions. Common concerns included the following:
- (a) The fair value measurement guidance is not detailed enough to allow them to measure fair value on a consistent basis.
  - (b) There is limited availability of practitioners in their jurisdictions who have the skills to apply the guidance (and as a result entities might be unfamiliar with applying the necessary judgements).
  - (c) There is limited access to market data to develop fair value measurements because there are few deep and liquid markets, there are often few willing buyers and sellers and prices often fluctuate considerably within short periods of time.
  - (d) Models, inputs and assumptions may be new and may not be comparable across entities because of rapidly developing socio-economic changes.
  - (e) Measuring fair value (and preparing the resulting disclosures) could be expensive.
- BC232 The IASB noted that because fair value is used in many IFRSs, knowledge about its application is necessary for applying IFRSs generally and noted that the concerns raised are not specific to entities in emerging and transition economies. Entities in developed economies faced similar challenges during the global financial crisis that started in 2007 and asked the IASB for guidance for measuring the fair value of equity instruments without active markets given the requirement to recognise them at fair value in IFRS 9. Furthermore, the IASB concluded that there should not be a different threshold for measuring fair value depending on jurisdiction. Only by performing fair value measurements will entities applying IFRSs learn how to do those measurements appropriately and robustly.
- BC233 Therefore, the IASB concluded that entities applying IFRSs would benefit from educational material to accompany IFRS 13. The IFRS Foundation sometimes publishes educational material that is leveraged from the standard-setting process to reinforce the goal of promoting the adoption and consistent application of a single set of high quality international accounting standards. The IASB asked the staff to develop educational material on fair value measurement that describes at a high level the thought process for measuring assets, liabilities and an entity's own equity instruments at fair value consistent with the objective of a fair value measurement.
- BC234 The IASB concluded that any educational material developed must benefit all entities equally. Thus, the educational material cannot benefit entities in emerging and transition economies without being made available to entities in developed economies.
- BC235 The IASB staff and the FASB staff will liaise during the development of the educational material.

## Convergence with US GAAP

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BC236 As noted above, the fair value measurement project was a joint project with the FASB. The boards worked together to ensure that fair value has the same meaning in IFRSs and in US GAAP and that their respective fair value measurement and disclosure requirements are the same (except for minor differences in wording and style).

BC237 The boards worked together to ensure that, to the extent possible, IFRS 13 and Topic 820 are identical. The following style differences remain:

- (a) There are differences in references to other IFRSs and US GAAP—For example, regarding related party transactions, IFRS 13 refers to IAS 24 *Related Party Disclosures* and Topic 820 refers to Topic 850 *Related Party Disclosures*.
- (b) There are differences in style—For example, IFRS 13 refers to *an entity* and Topic 820 refers to *a reporting entity*.
- (c) There are differences in spelling—For example, IFRS 13 refers to *labour costs* and Topic 820 refers to *labor costs*.
- (d) There are differences in whether references are to a particular jurisdiction or are generic—For example, IFRS 13 refers to *risk-free government securities* and Topic 820 refers to *US Treasury securities*.

The boards concluded that those differences will not result in inconsistent interpretations in practice by entities applying IFRSs or US GAAP.

BC238 In addition, IFRS 13 and Topic 820 have the following differences:

- (a) There are different accounting requirements in IFRSs and US GAAP for measuring the fair value of investments in investment companies. Topic 946 *Financial Services—Investment Companies* in US GAAP requires an investment company to recognise its underlying investments at fair value at each reporting period. Topic 820 provides a practical expedient that permits an entity with an investment in an investment company to use as a measure of fair value in specific circumstances the reported net asset value without adjustment. IFRS 10 *Consolidated Financial Statements* requires an investment company to consolidate its controlled underlying investments. Because IFRSs do not have accounting requirements that are specific to investment companies, the IASB decided that it would be difficult to identify when such a practical expedient could be applied given the different practices for calculating net asset values in jurisdictions around the world. For example, investment companies may report in accordance with national GAAP, which may have recognition and measurement requirements that differ from those in IFRSs (ie the underlying investments might not be measured at fair value, or they might be measured at fair value in accordance with national GAAP, not IFRSs). The boards are reviewing the accounting for investment companies as part of a separate project.
- (b) There are different requirements for measuring the fair value of a financial liability with a demand feature. In US GAAP, Topic 825 *Financial Instruments* and Topic 942 *Financial Services—Depository and Lending* describe the fair value measurement of a deposit liability as the amount payable on demand at the reporting date. In IFRSs, IFRS 13 states that the fair value measurement of a financial liability with a demand feature (eg demand deposits) cannot be less than the present value of the amount payable on demand. That requirement in IFRS 13 was relocated unchanged from IAS 39 and IFRS 9 as a consequence of the IASB's fair value measurement project.
- (c) There are different disclosure requirements in IFRSs and US GAAP. For example:
  - (i) Because IFRSs generally do not allow net presentation for derivatives, the amounts disclosed for fair value measurements categorised within Level 3 of the fair value hierarchy might differ. The boards are reviewing the presentation requirements for offsetting financial assets and financial liabilities in their joint project on the accounting for financial instruments.
  - (ii) IFRSs require a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorised within Level 3 of the fair value hierarchy (that disclosure was previously in IFRS 7). The boards will analyse the feasibility of incorporating information about interrelationships between unobservable inputs into a quantitative measurement uncertainty analysis disclosure. After completing that analysis, the boards will decide whether to require such a disclosure.
  - (iii) Topic 820 has different disclosure requirements for non-public entities. The FASB concluded that some of the disclosures should not be required for non-public entities because of the characteristics of the users of the financial statements of those entities. The FASB

considered the ability of those users to access information about the financial position of the entity and the relevance to those users of the information that would be provided by the requirements in the disclosure amendments. In contrast, the IASB recently completed a project on the accounting for small and medium-sized entities. As a result, the *IFRS for Small and Medium-Sized Entities* addresses the accounting for entities that do not have public accountability, and the disclosures about their fair value measurements.

## **Cost-benefit considerations**

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- BC239 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. To meet that objective, the IASB seeks to ensure that an IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs to implement a new standard might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.
- BC240 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the IASB considers the following:
- (a) the costs incurred by preparers of financial statements;
  - (b) the costs incurred by users of financial statements when information is not available;
  - (c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information; and
  - (d) the benefit of better economic decision-making as a result of improved financial reporting.
- BC241 IFRS 13 defines fair value, provides a framework for measuring fair value and requires disclosures about fair value measurements. A clear definition of fair value, together with a framework for measuring fair value that eliminates inconsistencies across IFRSs that have contributed to diversity in practice, should improve consistency in application, thereby enhancing the comparability of information reported in financial statements.
- BC242 The disclosures about fair value measurements would increase transparency and improve the quality of information provided to users of financial statements. In developing the disclosure requirements in IFRS 13, the IASB obtained input from users and preparers of financial statements and other interested parties to enable the IASB to assess whether the disclosures could be provided within reasonable cost-benefit constraints.
- BC243 Although the framework for measuring fair value builds on current practice and requirements, some methods in IFRS 13 may result in a change to practice for some entities. Furthermore, some entities will need to make systems and operational changes, thereby incurring incremental costs. Other entities also might incur incremental costs in applying the measurement and disclosure requirements. However, the IASB concluded that the benefits resulting from increased consistency in application of fair value measurement requirements and enhanced comparability of fair value information and improved communication of that information to users of financial statements will continue. On balance, the IASB concluded that improvements in financial reporting resulting from the application of the requirements in IFRS 13 will exceed the increased costs of applying the requirements.

## **Summary of main changes from the exposure draft**

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- BC244 The main changes from the proposals in the exposure draft published in May 2009 are as follows:
- (a) IFRS 13 excludes from its scope share-based payment transactions in IFRS 2 and leasing transactions in IAS 17. The exposure draft proposed the following:
    - (i) replacing the term *fair value* with another term that reflects the measurement objective for share-based payment transactions in IFRS 2 and for reacquired rights in a business combination in IFRS 3.
    - (ii) excluding financial liabilities with a demand feature in IAS 39 from the scope of an IFRS on fair value measurement.

The exposure draft did not propose excluding leasing transactions from the scope of an IFRS on fair value measurement.

- (b) IFRS 13 requires fair value to be measured using the price in 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. The exposure draft proposed that fair value should be measured using the price in the most advantageous market.
- (c) IFRS 13 states that market participants have a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary. The exposure draft stated that market participants are presumed to be as knowledgeable as the entity about the asset or liability (ie there was no information asymmetry between market participants and the entity).
- (d) IFRS 13 contains detailed guidance for measuring the fair value of liabilities, including the compensation market participants would require to assume the liability and how a third-party credit enhancement affects the fair value of a liability. The exposure draft provided high level guidance.
- (e) IFRS 13 contains detailed guidance for measuring the fair value of an entity's own equity instruments. That guidance is consistent with the guidance for measuring the fair value of a liability. The exposure draft proposed requiring an entity to measure the fair value of its own equity instruments by reference to the fair value of the instrument held by a market participant as an asset (ie the corresponding asset) without providing information about when the fair value of the equity instrument might differ from the fair value of the corresponding asset.
- (f) IFRS 13 provides guidance for measuring the fair value of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk. The exposure draft proposed requiring financial assets to be measured using an in-exchange valuation premise.
- (g) IFRS 13 states that classes of asset or liability for disclosure purposes should be determined on the basis of the nature, characteristics and risks of the asset or liability and the level of the fair value hierarchy within which the fair value measurement is categorised. The exposure draft did not provide guidance for determining the appropriate class of asset or liability for disclosures about fair value measurements.
- (h) IFRS 13 provides examples of policies for when to recognise transfers between levels of the fair value hierarchy, such as the date of the transfer, the beginning of the reporting period or the end of the reporting period. IFRS 13 also states that the policy about the timing of recognising transfers must be the same for transfers into a level as that for transfers out of a level. The exposure draft did not provide guidance for determining when transfers are deemed to have occurred or propose to require an entity to disclose its policy for determining when transfers between levels are recognised.
- (i) IFRS 13 requires a narrative discussion of the sensitivity of a fair value measurement categorised within Level 3 of the fair value hierarchy to changes in significant unobservable inputs and any interrelationships between those inputs that might magnify or mitigate the effect on the measurement. It also requires a quantitative sensitivity analysis for financial instruments categorised within Level 3 of the fair value hierarchy (that disclosure was relocated from IFRS 7). The exposure draft proposed a quantitative sensitivity analysis for assets and liabilities categorised within Level 3 of the fair value hierarchy. The IASB re-exposed that proposal, including a requirement to take into account the interrelationships between unobservable inputs in the analysis (referred to as a measurement uncertainty analysis disclosure). Respondents were concerned about whether the proposal would be operational. The boards will continue to assess whether a quantitative measurement uncertainty analysis disclosure would be practical after the IFRS is issued, with the aim of reaching a conclusion about whether to require such a disclosure at a later date.
- (j) IFRS 13 requires an entity to disclose information about its valuation processes (eg valuation policies and procedures) for fair value measurements categorised within Level 3 of the fair value hierarchy. The disclosure is similar to the description of valuation processes in the IASB's Fair Value Expert Advisory Panel's October 2008 report.
- (k) If the highest and best use of a non-financial asset differs from its current use, IFRS 13 requires an entity to disclose that fact and why the asset is being used in a manner that differs from its highest and best use. The exposure draft proposed requiring an entity to disclose the value of the asset assuming its current use, the amount by which the fair value of the asset differs from its fair value in its current use (ie the incremental value of the asset group) and the reasons the asset is being used in a manner that differs from its highest and best use.

## **Appendix**

### **Amendments to the Basis for Conclusions on other IFRSs**

*This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 13 and the related amendments to other IFRSs. Amended paragraphs are shown with new text underlined and deleted text struck through.*

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*The amendments contained in this appendix when IFRS 13 was issued in 2011 have been incorporated into the text of the Basis for Conclusions on the relevant IFRSs published in this volume.*

**IFRS 13 FAIR VALUE MEASUREMENT  
ILLUSTRATIVE EXAMPLES**

	<i>from paragraph</i>
<b>HIGHEST AND BEST USE AND VALUATION PREMISE</b>	<b>IE2</b>
Example 1—Asset group	IE3
Example 2—Land	IE7
Example 3—Research and development project	IE9
<b>USE OF MULTIPLE VALUATION TECHNIQUES</b>	<b>IE10</b>
Example 4—Machine held and used	IE11
Example 5—Software asset	IE15
<b>PRINCIPAL (OR MOST ADVANTAGEOUS) MARKET</b>	<b>IE18</b>
Example 6—Level 1 principal (or most advantageous) market	IE19
<b>TRANSACTION PRICES AND FAIR VALUE AT INITIAL RECOGNITION</b>	<b>IE23</b>
Example 7—Interest rate swap at initial recognition	IE24
<b>RESTRICTED ASSETS</b>	<b>IE27</b>
Example 8—Restriction on the sale of an equity instrument	IE28
Example 9—Restrictions on the use of an asset	IE29
<b>MEASURING LIABILITIES</b>	<b>IE30</b>
Example 10—Structured note	IE34
Example 11—Decommissioning liability	IE35
Example 12—Debt obligation: quoted price	IE40
Example 13—Debt obligation: present value technique	IE43
<b>MEASURING FAIR VALUE WHEN THE VOLUME OR LEVEL OF ACTIVITY FOR AN ASSET OR A LIABILITY HAS SIGNIFICANTLY DECREASED</b>	<b>IE48</b>
Example 14—Estimating a market rate of return when the volume or level of activity for an asset has significantly decreased	IE49
<b>FAIR VALUE DISCLOSURES</b>	<b>IE59</b>
Example 15—Assets measured at fair value	IE60
Example 16—Reconciliation of fair value measurements categorised within Level 3 of the fair value hierarchy	IE61
Example 17—Valuation techniques and inputs	IE63
Example 18—Valuation processes	IE65
Example 19—Information about sensitivity to changes in significant unobservable inputs	IE66
<b>APPENDIX</b>	
Amendments to the guidance on other IFRSs	

## IFRS 13 *Fair Value Measurement* Illustrative examples

*These examples accompany, but are not part of, IFRS 13. They illustrate aspects of IFRS 13 but are not intended to provide interpretative guidance.*

IE1 These examples portray hypothetical situations illustrating the judgements that might apply when an entity measures assets and liabilities at fair value in different valuation situations. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying IFRS 13.

### Highest and best use and valuation premise

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IE2 Examples 1–3 illustrate the application of the highest and best use and valuation premise concepts for non-financial assets.

#### Example 1—Asset group

IE3 An entity acquires assets and assumes liabilities in a business combination. One of the groups of assets acquired comprises Assets A, B and C. Asset C is billing software integral to the business developed by the acquired entity for its own use in conjunction with Assets A and B (ie the related assets). The entity measures the fair value of each of the assets individually, consistently with the specified unit of account for the assets. The entity determines that the highest and best use of the assets is their current use and that each asset would provide maximum value to market participants principally through its use in combination with other assets or with other assets and liabilities (ie its complementary assets and the associated liabilities). There is no evidence to suggest that the current use of the assets is not their highest and best use.

IE4 In this situation, the entity would sell the assets in the market in which it initially acquired the assets (ie the entry and exit markets from the perspective of the entity are the same). Market participant buyers with whom the entity would enter into a transaction in that market have characteristics that are generally representative of both strategic buyers (such as competitors) and financial buyers (such as private equity or venture capital firms that do not have complementary investments) and include those buyers that initially bid for the assets. Although market participant buyers might be broadly classified as strategic or financial buyers, in many cases there will be differences among the market participant buyers within each of those groups, reflecting, for example, different uses for an asset and different operating strategies.

IE5 As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:

- (a) Strategic buyer asset group. The entity determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (ie market participant synergies). Those assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold on its own at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are CU360,<sup>1</sup> CU260 and CU30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is CU650.
- (b) Financial buyer asset group. The entity determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (ie the billing software) would be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the financial buyer asset group are CU300, CU200 and CU100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is CU600.

IE6 The fair values of Assets A, B and C would be determined on the basis of the use of the assets as a group within the strategic buyer group (CU360, CU260 and CU30). Although the use of the assets within the strategic buyer group does not maximise the fair value of each of the assets individually, it maximises the fair value of the assets as a group (CU650).

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<sup>1</sup> In these examples, monetary amounts are denominated in 'currency units (CU)'.

## Example 2—Land

IE7 An entity acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of land is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, the entity determines that the land currently used as a site for a factory could be developed as a site for residential use (ie for high-rise apartment buildings) because market participants would take into account the potential to develop the site for residential use when pricing the land.

IE8 The highest and best use of the land would be determined by comparing both of the following:

- (a) the value of the land as currently developed for industrial use (ie the land would be used in combination with other assets, such as the factory, or with other assets and liabilities).
- (b) the value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (ie the land is to be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of those values. In situations involving real estate appraisal, the determination of highest and best use might take into account factors relating to the factory operations, including its assets and liabilities.

## Example 3—Research and development project

IE9 An entity acquires a research and development (R&D) project in a business combination. The entity does not intend to complete the project. If completed, the project would compete with one of its own projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (ie lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology. To measure the fair value of the project at initial recognition, the highest and best use of the project would be determined on the basis of its use by market participants. For example:

- (a) The highest and best use of the R&D project would be to continue development if market participants would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used (ie the asset would be used in combination with other assets or with other assets and liabilities). That might be the case if market participants do not have similar technology, either in development or commercialised. The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used with its complementary assets and the associated liabilities and that those assets and liabilities would be available to market participants.
- (b) The highest and best use of the R&D project would be to cease development if, for competitive reasons, market participants would lock up the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used. That might be the case if market participants have technology in a more advanced stage of development that would compete with the project if completed and the project would be expected to improve the prospects for their own competing technology if locked up. The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used (ie locked up) with its complementary assets and the associated liabilities and that those assets and liabilities would be available to market participants.
- (c) The highest and best use of the R&D project would be to cease development if market participants would discontinue its development. That might be the case if the project is not expected to provide a market rate of return if completed and would not otherwise provide defensive value if locked up. The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project on its own (which might be zero).

## Use of multiple valuation techniques

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IE10 The IFRS notes that a single valuation technique will be appropriate in some cases. In other cases multiple valuation techniques will be appropriate. Examples 4 and 5 illustrate the use of multiple valuation techniques.

## Example 4—Machine held and used

- IE11 An entity acquires a machine in a business combination. The machine will be held and used in its operations. The machine was originally purchased by the acquired entity from an outside vendor and, before the business combination, was customised by the acquired entity for use in its operations. However, the customisation of the machine was not extensive. The acquiring entity determines that the asset would provide maximum value to market participants through its use in combination with other assets or with other assets and liabilities (as installed or otherwise configured for use). There is no evidence to suggest that the current use of the machine is not its highest and best use. Therefore, the highest and best use of the machine is its current use in combination with other assets or with other assets and liabilities.
- IE12 The entity determines that sufficient data are available to apply the cost approach and, because the customisation of the machine was not extensive, the market approach. The income approach is not used because the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows. Furthermore, information about short-term and intermediate-term lease rates for similar used machinery that otherwise could be used to project an income stream (ie lease payments over remaining service lives) is not available. The market and cost approaches are applied as follows:
- (a) The market approach is applied using quoted prices for similar machines adjusted for differences between the machine (as customised) and the similar machines. The measurement reflects the price that would be received for the machine in its current condition (used) and location (installed and configured for use). The fair value indicated by that approach ranges from CU40,000 to CU48,000.
  - (b) The cost approach is applied by estimating the amount that would be required currently to construct a substitute (customised) machine of comparable utility. The estimate takes into account the condition of the machine and the environment in which it operates, including physical wear and tear (ie physical deterioration), improvements in technology (ie functional obsolescence), conditions external to the condition of the machine such as a decline in the market demand for similar machines (ie economic obsolescence) and installation costs. The fair value indicated by that approach ranges from CU40,000 to CU52,000.
- IE13 The entity determines that the higher end of the range indicated by the market approach is most representative of fair value and, therefore, ascribes more weight to the results of the market approach. That determination is made on the basis of the relative subjectivity of the inputs, taking into account the degree of comparability between the machine and the similar machines. In particular:
- (a) the inputs used in the market approach (quoted prices for similar machines) require fewer and less subjective adjustments than the inputs used in the cost approach.
  - (b) the range indicated by the market approach overlaps with, but is narrower than, the range indicated by the cost approach.
  - (c) there are no known unexplained differences (between the machine and the similar machines) within that range.

Accordingly, the entity determines that the fair value of the machine is CU48,000.

- IE14 If customisation of the machine was extensive or if there were not sufficient data available to apply the market approach (eg because market data reflect transactions for machines used on a stand-alone basis, such as a scrap value for specialised assets, rather than machines used in combination with other assets or with other assets and liabilities), the entity would apply the cost approach. When an asset is used in combination with other assets or with other assets and liabilities, the cost approach assumes the sale of the machine to a market participant buyer with the complementary assets and the associated liabilities. The price received for the sale of the machine (ie an exit price) would not be more than either of the following:
- (a) the cost that a market participant buyer would incur to acquire or construct a substitute machine of comparable utility; or
  - (b) the economic benefit that a market participant buyer would derive from the use of the machine.

## Example 5—Software asset

- IE15 An entity acquires a group of assets. The asset group includes an income-producing software asset internally developed for licensing to customers and its complementary assets (including a related database with which the software asset is used) and the associated liabilities. To allocate the cost of the group to the individual assets acquired, the entity measures the fair value of the software asset. The entity determines that the software asset would provide maximum value to market participants through its use in combination with other assets or with other assets and liabilities (ie its complementary assets and the associated liabilities). There is no evidence to suggest that the current use of the software asset is not its highest and

best use. Therefore, the highest and best use of the software asset is its current use. (In this case the licensing of the software asset, in and of itself, does not indicate that the fair value of the asset would be maximised through its use by market participants on a stand-alone basis.)

- IE16 The entity determines that, in addition to the income approach, sufficient data might be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available. The income and cost approaches are applied as follows:
- (a) The income approach is applied using a present value technique. The cash flows used in that technique reflect the income stream expected to result from the software asset (licence fees from customers) over its economic life. The fair value indicated by that approach is CU15 million.
  - (b) The cost approach is applied by estimating the amount that currently would be required to construct a substitute software asset of comparable utility (ie taking into account functional and economic obsolescence). The fair value indicated by that approach is CU10 million.
- IE17 Through its application of the cost approach, the entity determines that market participants would not be able to construct a substitute software asset of comparable utility. Some characteristics of the software asset are unique, having been developed using proprietary information, and cannot be readily replicated. The entity determines that the fair value of the software asset is CU15 million, as indicated by the income approach.

### **Principal (or most advantageous) market**

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- IE18 Example 6 illustrates the use of Level 1 inputs to measure the fair value of an asset that trades in different active markets at different prices.

#### **Example 6—Level 1 principal (or most advantageous) market**

- IE19 An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. In Market A, the price that would be received is CU26, transaction costs in that market are CU3 and the costs to transport the asset to that market are CU2 (ie the net amount that would be received is CU21). In Market B, the price that would be received is CU25, transaction costs in that market are CU1 and the costs to transport the asset to that market are CU2 (ie the net amount that would be received in Market B is CU22).
- IE20 If Market A is the principal market for the asset (ie the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (CU24).
- IE21 If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (ie the net amount that would be received in the respective markets).
- IE22 Because the entity would maximise the net amount that would be received for the asset in Market B (CU22), the fair value of the asset would be measured using the price in that market (CU25), less transport costs (CU2), resulting in a fair value measurement of CU23. Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

### **Transaction prices and fair value at initial recognition**

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- IE23 The IFRS clarifies that in many cases the transaction price, ie the price paid (received) for a particular asset (liability), will represent the fair value of that asset (liability) at initial recognition, but not presumptively. Example 7 illustrates when the price in a transaction involving a derivative instrument might (and might not) equal the fair value of the instrument at initial recognition.

#### **Example 7—Interest rate swap at initial recognition**

- IE24 Entity A (a retail counterparty) enters into an interest rate swap in a retail market with Entity B (a dealer) for no initial consideration (ie the transaction price is zero). Entity A can access only the retail market. Entity B can access both the retail market (ie with retail counterparties) and the dealer market (ie with dealer counterparties).
- IE25 From the perspective of Entity A, the retail market in which it initially entered into the swap is the principal market for the swap. If Entity A were to transfer its rights and obligations under the swap, it would do so

with a dealer counterparty in that retail market. In that case the transaction price (zero) would represent the fair value of the swap to Entity A at initial recognition, ie the price that Entity A would receive to sell or pay to transfer the swap in a transaction with a dealer counterparty in the retail market (ie an exit price). That price would not be adjusted for any incremental (transaction) costs that would be charged by that dealer counterparty.

- IE26 From the perspective of Entity B, the dealer market (not the retail market) is the principal market for the swap. If Entity B were to transfer its rights and obligations under the swap, it would do so with a dealer in that market. Because the market in which Entity B initially entered into the swap is different from the principal market for the swap, the transaction price (zero) would not necessarily represent the fair value of the swap to Entity B at initial recognition. If the fair value differs from the transaction price (zero), Entity B applies IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* to determine whether it recognises that difference as a gain or loss at initial recognition.

## Restricted assets

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- IE27 The effect on a fair value measurement arising from a restriction on the sale or use of an asset by an entity will differ depending on whether the restriction would be taken into account by market participants when pricing the asset. Examples 8 and 9 illustrate the effect of restrictions when measuring the fair value of an asset.

### Example 8—Restriction on the sale of an equity instrument

- IE28 An entity holds an equity instrument (a financial asset) for which sale is legally or contractually restricted for a specified period. (For example, such a restriction could limit sale to qualifying investors.) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants. In that case the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment will vary depending on all the following:
- (a) the nature and duration of the restriction;
  - (b) the extent to which buyers are limited by the restriction (eg there might be a large number of qualifying investors); and
  - (c) qualitative and quantitative factors specific to both the instrument and the issuer.

### Example 9—Restrictions on the use of an asset

- IE29 A donor contributes land in an otherwise developed residential area to a not-for-profit neighbourhood association. The land is currently used as a playground. The donor specifies that the land must continue to be used by the association as a playground in perpetuity. Upon review of relevant documentation (eg legal and other), the association determines that the fiduciary responsibility to meet the donor's restriction would not be transferred to market participants if the association sold the asset, ie the donor restriction on the use of the land is specific to the association. Furthermore, the association is not restricted from selling the land. Without the restriction on the use of the land by the association, the land could be used as a site for residential development. In addition, the land is subject to an easement (ie a legal right that enables a utility to run power lines across the land). Following is an analysis of the effect on the fair value measurement of the land arising from the restriction and the easement:
- (a) *Donor restriction on use of land.* Because in this situation the donor restriction on the use of the land is specific to the association, the restriction would not be transferred to market participants. Therefore, the fair value of the land would be the higher of its fair value used as a playground (ie the fair value of the asset would be maximised through its use by market participants in combination with other assets or with other assets and liabilities) and its fair value as a site for residential development (ie the fair value of the asset would be maximised through its use by market participants on a stand-alone basis), regardless of the restriction on the use of the land by the association.
  - (b) *Easement for utility lines.* Because the easement for utility lines is specific to (ie a characteristic of) the land, it would be transferred to market participants with the land. Therefore, the fair value

measurement of the land would take into account the effect of the easement, regardless of whether the highest and best use is as a playground or as a site for residential development.

## Measuring liabilities

- IE30 A fair value measurement of a liability assumes that the liability, whether it is a financial liability or a non-financial liability, is transferred to a market participant at the measurement date (ie the liability would remain outstanding and the market participant transferee would be required to fulfil the obligation; it would not be settled with the counterparty or otherwise extinguished on the measurement date).
- IE31 The fair value of a liability reflects the effect of non-performance risk. Non-performance risk relating to a liability includes, but may not be limited to, the entity's own credit risk. An entity takes into account the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value because those that hold the entity's obligations as assets would take into account the effect of the entity's credit standing when estimating the prices they would be willing to pay.
- IE32 For example, assume that Entity X and Entity Y each enter into a contractual obligation to pay cash (CU500) to Entity Z in five years. Entity X has a AA credit rating and can borrow at 6 per cent, and Entity Y has a BBB credit rating and can borrow at 12 per cent. Entity X will receive about CU374 in exchange for its promise (the present value of CU500 in five years at 6 per cent). Entity Y will receive about CU284 in exchange for its promise (the present value of CU500 in five years at 12 per cent). The fair value of the liability to each entity (ie the proceeds) incorporates that entity's credit standing.
- IE33 Examples 10–13 illustrate the measurement of liabilities and the effect of non-performance risk (including an entity's own credit risk) on a fair value measurement.

### Example 10—Structured note

- IE34 On 1 January 20X7 Entity A, an investment bank with a AA credit rating, issues a five-year fixed rate note to Entity B. The contractual principal amount to be paid by Entity A at maturity is linked to an equity index. No credit enhancements are issued in conjunction with or otherwise related to the contract (ie no collateral is posted and there is no third-party guarantee). Entity A designated this note as at fair value through profit or loss. The fair value of the note (ie the obligation of Entity A) during 20X7 is measured using an expected present value technique. Changes in fair value are as follows:
- Fair value at 1 January 20X7.* The expected cash flows used in the expected present value technique are discounted at the risk-free rate using the government bond curve at 1 January 20X7, plus the current market observable AA corporate bond spread to government bonds, if non-performance risk is not already reflected in the cash flows, adjusted (either up or down) for Entity A's specific credit risk (ie resulting in a credit-adjusted risk-free rate). Therefore, the fair value of Entity A's obligation at initial recognition takes into account non-performance risk, including that entity's credit risk, which presumably is reflected in the proceeds.
  - Fair value at 31 March 20X7.* During March 20X7 the credit spread for AA corporate bonds widens, with no changes to the specific credit risk of Entity A. The expected cash flows used in the expected present value technique are discounted at the risk-free rate using the government bond curve at 31 March 20X7, plus the current market observable AA corporate bond spread to government bonds, if non-performance risk is not already reflected in the cash flows, adjusted for Entity A's specific credit risk (ie resulting in a credit-adjusted risk-free rate). Entity A's specific credit risk is unchanged from initial recognition. Therefore, the fair value of Entity A's obligation changes as a result of changes in credit spreads generally. Changes in credit spreads reflect current market participant assumptions about changes in non-performance risk generally, changes in liquidity risk and the compensation required for assuming those risks.
  - Fair value at 30 June 20X7.* As of 30 June 20X7 there have been no changes to the AA corporate bond spreads. However, on the basis of structured note issues corroborated with other qualitative information, Entity A determines that its own specific creditworthiness has strengthened within the AA credit spread. The expected cash flows used in the expected present value technique are discounted at the risk-free rate using the government bond yield curve at 30 June 20X7, plus the current market observable AA corporate bond spread to government bonds (unchanged from 31 March 20X7), if non-performance risk is not already reflected in the cash flows, adjusted for Entity A's specific credit risk (ie resulting in a credit-adjusted risk-free rate). Therefore, the fair value of the obligation of Entity A changes as a result of the change in its own specific credit risk within the AA corporate bond spread.

**Example 11—Decommissioning liability**

- IE35 On 1 January 20X1 Entity A assumes a decommissioning liability in a business combination. The entity is legally required to dismantle and remove an offshore oil platform at the end of its useful life, which is estimated to be 10 years.
- IE36 On the basis of paragraphs B23–B30 of the IFRS, Entity A uses the expected present value technique to measure the fair value of the decommissioning liability.
- IE37 If Entity A was contractually allowed to transfer its decommissioning liability to a market participant, Entity A concludes that a market participant would use all the following inputs, probability-weighted as appropriate, when estimating the price it would expect to receive:
  - (a) labour costs;
  - (b) allocation of overhead costs;
  - (c) the compensation that a market participant would require for undertaking the activity and for assuming the risk associated with the obligation to dismantle and remove the asset. Such compensation includes both of the following:
    - (i) profit on labour and overhead costs; and
    - (ii) the risk that the actual cash outflows might differ from those expected, excluding inflation;
  - (d) effect of inflation on estimated costs and profits;
  - (e) time value of money, represented by the risk-free rate; and
  - (f) non-performance risk relating to the risk that Entity A will not fulfil the obligation, including Entity A’s own credit risk.

IE38 The significant assumptions used by Entity A to measure fair value are as follows:

- (a) Labour costs are developed on the basis of current marketplace wages, adjusted for expectations of future wage increases, required to hire contractors to dismantle and remove offshore oil platforms. Entity A assigns probability assessments to a range of cash flow estimates as follows:

Cash flow estimate (CU)	Probability assessment	Expected cash flows (CU)
100,000	25%	25,000
125,000	50%	62,500
175,000	25%	43,750
		CU131,250

The probability assessments are developed on the basis of Entity A’s experience with fulfilling obligations of this type and its knowledge of the market.

- (b) Entity A estimates allocated overhead and equipment operating costs using the rate it applies to labour costs (80 per cent of expected labour costs). This is consistent with the cost structure of market participants.
- (c) Entity A estimates the compensation that a market participant would require for undertaking the activity and for assuming the risk associated with the obligation to dismantle and remove the asset as follows:
  - (i) A third-party contractor typically adds a mark-up on labour and allocated internal costs to provide a profit margin on the job. The profit margin used (20 per cent) represents Entity A’s understanding of the operating profit that contractors in the industry generally earn to dismantle and remove offshore oil platforms. Entity A concludes that this rate is consistent with the rate that a market participant would require as compensation for undertaking the activity.
  - (ii) A contractor would typically require compensation for the risk that the actual cash outflows might differ from those expected because of the uncertainty inherent in locking in today’s

price for a project that will not occur for 10 years. Entity A estimates the amount of that premium to be 5 per cent of the expected cash flows, including the effect of inflation.

- (d) Entity A assumes a rate of inflation of 4 per cent over the 10-year period on the basis of available market data.
- (e) The risk-free rate of interest for a 10-year maturity on 1 January 20X1 is 5 per cent. Entity A adjusts that rate by 3.5 per cent to reflect its risk of non-performance (ie the risk that it will not fulfil the obligation), including its credit risk. Therefore, the discount rate used to compute the present value of the cash flows is 8.5 per cent.

IE39 Entity A concludes that its assumptions would be used by market participants. In addition, Entity A does not adjust its fair value measurement for the existence of a restriction preventing it from transferring the liability. As illustrated in the following table, Entity A measures the fair value of its decommissioning liability as CU194,879.

	Expected cash flows(CU)
	1 January 20X1
Expected labour costs	131,250
Allocated overhead and equipment costs (0.80 × CU131,250)	105,000
Contractor's profit mark-up [0.20 × (CU131,250 + CU105,000)]	47,250
Expected cash flows before inflation adjustment	283,500
Inflation factor (4% for 10 years)	1.4802
Expected cash flows adjusted for inflation	419,637
Market risk premium (0.05 × CU419,637)	20,982
Expected cash flows adjusted for market risk	440,619
Expected present value using discount rate of 8.5% for 10 years	194,879

### Example 12—Debt obligation: quoted price

- IE40 On 1 January 20X1 Entity B issues at par a CU2 million BBB-rated exchange-traded five-year fixed rate debt instrument with an annual 10 per cent coupon. Entity B designated this financial liability as at fair value through profit or loss.
- IE41 On 31 December 20X1 the instrument is trading as an asset in an active market at CU929 per CU1,000 of par value after payment of accrued interest. Entity B uses the quoted price of the asset in an active market as its initial input into the fair value measurement of its liability (CU929 × [CU2 million ÷ CU1,000] = CU1,858,000).
- IE42 In determining whether the quoted price of the asset in an active market represents the fair value of the liability, Entity B evaluates whether the quoted price of the asset includes the effect of factors not applicable to the fair value measurement of a liability, for example, whether the quoted price of the asset includes the effect of a third-party credit enhancement if that credit enhancement would be separately accounted for from the perspective of the issuer. Entity B determines that no adjustments are required to the quoted price of the asset. Accordingly, Entity B concludes that the fair value of its debt instrument at 31 December 20X1 is CU1,858,000. Entity B categorises and discloses the fair value measurement of its debt instrument within Level 1 of the fair value hierarchy.

### Example 13—Debt obligation: present value technique

- IE43 On 1 January 20X1 Entity C issues at par in a private placement a CU2 million BBB-rated five-year fixed rate debt instrument with an annual 10 per cent coupon. Entity C designated this financial liability as at fair value through profit or loss.

- IE44 At 31 December 20X1 Entity C still carries a BBB credit rating. Market conditions, including available interest rates, credit spreads for a BBB-quality credit rating and liquidity, remain unchanged from the date the debt instrument was issued. However, Entity C's credit spread has deteriorated by 50 basis points because of a change in its risk of non-performance. After taking into account all market conditions, Entity C concludes that if it was to issue the instrument at the measurement date, the instrument would bear a rate of interest of 10.5 per cent or Entity C would receive less than par in proceeds from the issue of the instrument.
- IE45 For the purpose of this example, the fair value of Entity C's liability is calculated using a present value technique. Entity C concludes that a market participant would use all the following inputs (consistently with paragraphs B12–B30 of the IFRS) when estimating the price the market participant would expect to receive to assume Entity C's obligation:
- (a) the terms of the debt instrument, including all the following:
    - (i) coupon of 10 per cent;
    - (ii) principal amount of CU2 million; and
    - (iii) term of four years.
  - (b) the market rate of interest of 10.5 per cent (which includes a change of 50 basis points in the risk of non-performance from the date of issue).
- IE46 On the basis of its present value technique, Entity C concludes that the fair value of its liability at 31 December 20X1 is CU1,968,641.
- IE47 Entity C does not include any additional input into its present value technique for risk or profit that a market participant might require for compensation for assuming the liability. Because Entity C's obligation is a financial liability, Entity C concludes that the interest rate already captures the risk or profit that a market participant would require as compensation for assuming the liability. Furthermore, Entity C does not adjust its present value technique for the existence of a restriction preventing it from transferring the liability.

## **Measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased**

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- IE48 Example 14 illustrates the use of judgement when measuring the fair value of a financial asset when there has been a significant decrease in the volume or level of activity for the asset when compared with normal market activity for the asset (or similar assets).

### **Example 14—Estimating a market rate of return when the volume or level of activity for an asset has significantly decreased**

- IE49 Entity A invests in a junior AAA-rated tranche of a residential mortgage-backed security on 1 January 20X8 (the issue date of the security). The junior tranche is the third most senior of a total of seven tranches. The underlying collateral for the residential mortgage-backed security is unguaranteed non-conforming residential mortgage loans that were issued in the second half of 20X6.
- IE50 At 31 March 20X9 (the measurement date) the junior tranche is now A-rated. This tranche of the residential mortgage-backed security was previously traded through a brokered market. However, trading volume in that market was infrequent, with only a few transactions taking place per month from 1 January 20X8 to 30 June 20X8 and little, if any, trading activity during the nine months before 31 March 20X9.
- IE51 Entity A takes into account the factors in paragraph B37 of the IFRS to determine whether there has been a significant decrease in the volume or level of activity for the junior tranche of the residential mortgage-backed security in which it has invested. After evaluating the significance and relevance of the factors, Entity A concludes that the volume and level of activity of the junior tranche of the residential mortgage-backed security have significantly decreased. Entity A supported its judgement primarily on the basis that there was little, if any, trading activity for an extended period before the measurement date.
- IE52 Because there is little, if any, trading activity to support a valuation technique using a market approach, Entity A decides to use an income approach using the discount rate adjustment technique described in paragraphs B18–B22 of the IFRS to measure the fair value of the residential mortgage-backed security at the measurement date. Entity A uses the contractual cash flows from the residential mortgage-backed security (see also paragraphs 67 and 68 of the IFRS).

- IE53 Entity A then estimates a discount rate (ie a market rate of return) to discount those contractual cash flows. The market rate of return is estimated using both of the following:
- (a) the risk-free rate of interest.
  - (b) estimated adjustments for differences between the available market data and the junior tranche of the residential mortgage-backed security in which Entity A has invested. Those adjustments reflect available market data about expected non-performance and other risks (eg default risk, collateral value risk and liquidity risk) that market participants would take into account when pricing the asset in an orderly transaction at the measurement date under current market conditions.
- IE54 Entity A took into account the following information when estimating the adjustments in paragraph IE53(b):
- (a) the credit spread for the junior tranche of the residential mortgage-backed security at the issue date as implied by the original transaction price.
  - (b) the change in the credit spread implied by any observed transactions from the issue date to the measurement date for comparable residential mortgage-backed securities or on the basis of relevant indices.
  - (c) the characteristics of the junior tranche of the residential mortgage-backed security compared with comparable residential mortgage-backed securities or indices, including all the following:
    - (i) the quality of the underlying assets, ie information about the performance of the underlying mortgage loans such as delinquency and foreclosure rates, loss experience and prepayment rates;
    - (ii) the seniority or subordination of the residential mortgage-backed security tranche held; and
    - (iii) other relevant factors.
  - (d) relevant reports issued by analysts and rating agencies.
  - (e) quoted prices from third parties such as brokers or pricing services.
- IE55 Entity A estimates that one indication of the market rate of return that market participants would use when pricing the junior tranche of the residential mortgage-backed security is 12 per cent (1,200 basis points). This market rate of return was estimated as follows:
- (a) Begin with 300 basis points for the relevant risk-free rate of interest at 31 March 20X9.
  - (b) Add 250 basis points for the credit spread over the risk-free rate when the junior tranche was issued in January 20X8.
  - (c) Add 700 basis points for the estimated change in the credit spread over the risk-free rate of the junior tranche between 1 January 20X8 and 31 March 20X9. This estimate was developed on the basis of the change in the most comparable index available for that time period.
  - (d) Subtract 50 basis points (net) to adjust for differences between the index used to estimate the change in credit spreads and the junior tranche. The referenced index consists of subprime mortgage loans, whereas Entity A's residential mortgage-backed security consists of similar mortgage loans with a more favourable credit profile (making it more attractive to market participants). However, the index does not reflect an appropriate liquidity risk premium for the junior tranche under current market conditions. Thus, the 50 basis point adjustment is the net of two adjustments:
    - (i) the first adjustment is a 350 basis point subtraction, which was estimated by comparing the implied yield from the most recent transactions for the residential mortgage-backed security in June 20X8 with the implied yield in the index price on those same dates. There was no information available that indicated that the relationship between Entity A's security and the index has changed.
    - (ii) the second adjustment is a 300 basis point addition, which is Entity A's best estimate of the additional liquidity risk inherent in its security (a cash position) when compared with the index (a synthetic position). This estimate was derived after taking into account liquidity risk premiums implied in recent cash transactions for a range of similar securities.
- IE56 As an additional indication of the market rate of return, Entity A takes into account two recent indicative quotes (ie non-binding quotes) provided by reputable brokers for the junior tranche of the residential mortgage-backed security that imply yields of 15–17 per cent. Entity A is unable to evaluate the valuation technique(s) or inputs used to develop the quotes. However, Entity A is able to confirm that the quotes do not reflect the results of transactions.

- IE57 Because Entity A has multiple indications of the market rate of return that market participants would take into account when measuring fair value, it evaluates and weights the respective indications of the rate of return, considering the reasonableness of the range indicated by the results.
- IE58 Entity A concludes that 13 per cent is the point within the range of indications that is most representative of fair value under current market conditions. Entity A places more weight on the 12 per cent indication (ie its own estimate of the market rate of return) for the following reasons:
- Entity A concluded that its own estimate appropriately incorporated the risks (eg default risk, collateral value risk and liquidity risk) that market participants would use when pricing the asset in an orderly transaction under current market conditions.
  - The broker quotes were non-binding and did not reflect the results of transactions, and Entity A was unable to evaluate the valuation technique(s) or inputs used to develop the quotes.

## Fair value disclosures

- IE59 Examples 15–19 illustrate the disclosures required by paragraphs 92, 93(a), (b) and (d)–(h)(i) and 99 of the IFRS.

### Example 15—Assets measured at fair value

- IE60 For assets and liabilities measured at fair value at the end of the reporting period, the IFRS requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. An entity might disclose the following for assets to comply with paragraph 93(a) and (b) of the IFRS:

(CU in millions)	Fair value measurements at the end of the reporting period using				Total gains (losses)
	31/12/X9	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
<b>Recurring fair value measurements</b>					
Trading equity securities <sup>(a)</sup> :					
Real estate industry	93	70	23		
Oil and gas industry	45	45			
Other	15	15			
Total trading equity securities	153	130	23		
Other equity securities <sup>a</sup> :					
Financial services industry	150	150			
Healthcare industry	163	110		53	
Energy industry	32			32	
Private equity fund investments <sup>b</sup>	25			25	
Other	15	15			
Total other equity securities	385	275		110	
Debt securities:					
Residential mortgage-backed securities	149		24	125	
Commercial mortgage-backed securities	50			50	
Collateralised debt obligations	35			35	
Risk-free government securities	85	85			
Corporate bonds	93	9	84		
Total debt securities	412	94	108	210	

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Description	31/12/X9	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total gains (losses)
<b>Hedge fund investments:</b>					
Equity long/short	55		55		
Global opportunities	35		35		
High-yield debt securities	90			90	
Total hedge fund investments	180		90	90	
<b>Derivatives:</b>					
Interest rate contracts	57		57		
Foreign exchange contracts	43		43		
Credit contracts	38			38	
Commodity futures contracts	78	78			
Commodity forward contracts	20		20		
Total derivatives	236	78	120	38	
<b>Investment properties:</b>					
Commercial—Asia	31			31	
Commercial—Europe	27			27	
Total investment properties	58			58	
Total recurring fair value measurements	1,424	577	341	506	
<b>Non-recurring fair value measurements</b>					
Assets held for sale <sup>c</sup>	26		26		(15)
Total non-recurring fair value measurements	26		26		(15)

- (a) On the basis of its analysis of the nature, characteristics and risks of the securities, the entity has determined that presenting them by industry is appropriate.
- (b) On the basis of its analysis of the nature, characteristics and risks of the investments, the entity has determined that presenting them as a single class is appropriate.
- (c) In accordance with IFRS 5, assets held for sale with a carrying amount of CU35 million were written down to their fair value of CU26 million, less costs to sell of CU6 million (or CU20 million), resulting in a loss of CU15 million, which was included in profit or loss for the period.

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

### Example 16—Reconciliation of fair value measurements categorised within Level 3 of the fair value hierarchy

IE61 For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, the IFRS requires a reconciliation from the opening balances to the closing balances for each class of assets and liabilities. An entity might disclose the following for assets to comply with paragraph 93(e) and (f) of the IFRS:

(CU in millions)	Fair value measurements using significant unobservable inputs (Level 3)										
	Other equity securities			Debt securities			Hedge fund investments	Derivatives	Investment properties		Total
	Healthcare industry	Energy industry	Private equity fund	Residential mortgage-backed securities	Commercial mortgage-backed securities	Collateralised debt obligations	High-yield debt securities	Credit contracts	Asia	Europe	
Opening balance	49	28	20	105	39	25	145	30	28	26	495
Transfers into Level 3				60 <sup>a b</sup>							60
Transfers out of Level 3				(5) <sup>b c</sup>							(5)
Total gains or losses for the period											
Included in profit or loss			5	(23)	(5)	(7)	7	5	3	1	(14)
Included in other comprehensive income	3	1									4
Purchases, issues, sales and settlements											
Purchases	1	3			16	17		18			55
Issues											
Sales				(12)			(62)				(74)
Settlements								(15)			(15)
Closing balance	<u>53</u>	<u>32</u>	<u>25</u>	<u>125</u>	<u>50</u>	<u>35</u>	<u>90</u>	<u>38</u>	<u>31</u>	<u>27</u>	<u>506</u>
Change in unrealised gains or losses for the period included in profit or loss for assets held at the end of the reporting period			<u>5</u>	<u>(3)</u>	<u>(5)</u>	<u>(7)</u>	<u>(5)</u>	<u>2</u>	<u>3</u>	<u>1</u>	<u>(9)</u>

- (a) Transferred from Level 2 to Level 3 because of a lack of observable market data, resulting from a decrease in market activity for the securities.
- (b) The entity's policy is to recognise transfers into and transfers out of Level 3 as of the date of the event or change in circumstances that caused the transfer.
- (c) Transferred from Level 3 to Level 2 because observable market data became available for the securities.
- (Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

IE62 Gains and losses included in profit or loss for the period (above) are presented in financial income and non-financial income as follows:

(CU in millions)	Financial income	Non-financial income
Total gains or losses for the period included in profit or loss	<u>(18)</u>	<u>4</u>
Change in unrealised gains or losses for the period included in profit or loss for assets held at the end of the reporting period	<u>(13)</u>	<u>4</u>

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

## Example 17—Valuation techniques and inputs

IE63 For fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, the IFRS requires an entity to disclose a description of the valuation technique(s) and the inputs used in the fair value measurement. For fair value measurements categorised within Level 3 of the fair value hierarchy, information about the significant unobservable inputs used must be quantitative. An entity might disclose the following for assets to comply with the requirement to disclose the significant unobservable inputs used in the fair value measurement in accordance with paragraph 93(d) of the IFRS: IE64 In addition, an entity should provide additional information that will help users of its financial statements to evaluate the quantitative information disclosed. An entity might disclose some or all the following to comply with paragraph 92 of the IFRS:

<b>Qualitative information about fair value measurements using significant unobservable inputs (Level 3)</b>				
(CU in millions)				
Description	Fair value at 31/12/X9	Valuation technique(s)	Unobservable input	Range (weighted average)
<b>Other equity securities:</b>				
Healthcare industry	53	Discounted cash flow	weighted average cost of capital	7%–16% (12.1%)
			long-term revenue growth rate	2%–5% (4.2%)
			long-term pre-tax operating margin	3%–20% (10.3%)
			discount for lack of marketability <sup>a</sup>	5%–20% (17%)
			control premium <sup>a</sup>	10%–30% (20%)
		Market comparable companies	EBITDA multiple <sup>b</sup>	10–13 (11.3)
			revenue multiple <sup>b</sup>	1.5–2.0 (1.7)
			discount for lack of marketability <sup>a</sup>	5%–20% (17%)
			control premium <sup>a</sup>	10%–30% (20%)
Energy industry	32	Discounted cash flow	weighted average cost of capital	8%–12% (11.1%)
			long-term revenue growth rate	3%–5.5% (4.2%)
			long-term pre-tax operating margin	7.5%–13% (9.2%)
			discount for lack of marketability <sup>a</sup>	5%–20% (10%)
			control premium <sup>a</sup>	10%–20% (12%)
		Market comparable companies	EBITDA multiple <sup>b</sup>	6.5–12 (9.5)
			revenue multiple <sup>b</sup>	1.0–3.0 (2.0)
			discount for lack of marketability <sup>a</sup>	5%–20% (10%)
			control premium <sup>a</sup>	10%–20% (12%)
Private equity fund investments	25	Net asset value(c)	n/a	n/a
<b>Debt securities:</b>				
Residential mortgage-backed securities	125	Discounted cash flow	constant prepayment rate	3.5%–5.5% (4.5%)
			probability of default	5%–50% (10%)
			loss severity	40%–100% (60%)
Commercial mortgage-backed securities	50	Discounted cash flow	constant prepayment rate	3%–5% (4.1%)
			probability of default	2%–25% (5%)
			loss severity	10%–50% (20%)
Collateralised debt obligations	35	Consensus pricing	offered quotes	20–45
			comparability adjustments (%)	-10%–+15% (+5%)
<b>Hedge fund investments:</b>				
High-yield debt securities	90	Net asset value <sup>c</sup>	n/a	n/a
<b>Derivatives:</b>				
Credit contracts	38	Option model	annualised volatility of credit <sup>d</sup>	10%–20%
			counterparty credit risk <sup>e</sup>	0.5%–3.5%
			own credit risk <sup>e</sup>	0.3%–2.0

**continued...**

<i>...continued</i>				
Description	Fair value at 31/12/X9	Valuation technique(s)	Unobservable input	Range (weighted average)
<b>Investment properties:</b>				
Commercial - Asia	31	Discounted cash flow	long-term net operating income margin cap rate	18%–32% (20%) 0.08–0.12 (0.10).
		Market comparable approach	price per square metre (USD)	\$3,000–\$7,000 (\$4,500)
Commercial – Europe	27	Discounted cash flow	long-term net operating income margin cap rate	15%–25% (18%) 0.06–0.10 (0.08).
		Market comparable approach	price per square metre (EUR)	€4,000–€12,000 (€8,500)

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

- (a) Represents amounts used when the entity has determined that market participants would take into account these premiums and discounts when pricing the investments.
- (b) Represents amounts used when the entity has determined that market participants would use such multiples when pricing investments.
- (c) The entity has determined that the reported net asset value represents fair value at the end of the reporting period.
- (d) Represents the range of the volatility curves used in the valuation analysis that the entity has determined market participants would use when pricing the contract.
- (e) Represents the range of the credit default swap spread curves used in the valuation analysis that the entity has determined market participants would use when pricing the contracts.

IE64 In addition, an entity should provide additional information that will help users of its financial statements to evaluate the quantitative information disclosed. An entity might disclose some or all of the following to comply with paragraph 92 of the IFRS:

- (a) the nature of the item being measured at fair value, including the characteristics of the item being measured that are taken into account in the determination of relevant inputs. For example, for residential mortgage-backed securities, an entity might disclose the following:
  - (i) the types of underlying loans (eg prime loans or sub-prime loans)
  - (ii) collateral
  - (iii) guarantees or other credit enhancements
  - (iv) seniority level of the tranches of securities
  - (v) the year of issue
  - (vi) the weighted-average coupon rate of the underlying loans and the securities
  - (vii) the weighted-average maturity of the underlying loans and the securities
  - (viii) the geographical concentration of the underlying loans
  - (ix) information about the credit ratings of the securities.
- (b) how third-party information such as broker quotes, pricing services, net asset values and relevant market data was taken into account when measuring fair value.

### Example 18—Valuation processes

IE65 For fair value measurements categorised within Level 3 of the fair value hierarchy, the IFRS requires an entity to disclose a description of the valuation processes used by the entity. An entity might disclose the following to comply with paragraph 93(g) of the IFRS:

- (a) for the group within the entity that decides the entity's valuation policies and procedures:
  - (i) its description;
  - (ii) to whom that group reports; and
  - (iii) the internal reporting procedures in place (eg whether and, if so, how pricing, risk management or audit committees discuss and assess the fair value measurements);
- (b) the frequency and methods for calibration, back testing and other testing procedures of pricing models;

- (c) the process for analysing changes in fair value measurements from period to period;
- (d) how the entity determined that third-party information, such as broker quotes or pricing services, used in the fair value measurement was developed in accordance with the IFRS; and
- (e) the methods used to develop and substantiate the unobservable inputs used in a fair value measurement.

### **Example 19—Information about sensitivity to changes in significant unobservable inputs**

IE66 For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, the IFRS requires an entity to provide a narrative description of the sensitivity of the fair value measurement to changes in significant unobservable inputs and a description of any interrelationships between those unobservable inputs. An entity might disclose the following about its residential mortgage-backed securities to comply with paragraph 93(h)(i) of the IFRS:

The significant unobservable inputs used in the fair value measurement of the entity's residential mortgage-backed securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

## **Appendix**

### **Amendments to guidance on other IFRSs**

*The following amendments to guidance on other IFRSs are necessary in order to ensure consistency with IFRS 13 Fair Value Measurement and the related amendments to other IFRSs. Amended paragraphs are shown with new text underlined and deleted text struck through.*

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*The amendments contained in this appendix when IFRS 13 was issued in 2011 have been incorporated into the guidance on the relevant IFRSs published in this volume.*