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IFRS 13 “Fair Value Measurement” Key points of the new standard in 40 questions and answers

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Introduction

The accounting standard IFRS 13 "Fair value measurement" was published in May 2011. It represents the outcome of six years of IASB discussions, largely conducted jointly with the FASB.

The debates were long and difficult, largely for the following reasons:

- The first relates to the IASB's desire to publish a standard setting out "how" to determine the fair value of an asset or a liability without ever addressing the question of "when" to do so. Establishing what a fair value should be without being able to ask about the circumstances in which it should be used disconcerted many commentators.
- The second reason, more context-specific, relates to the financial crisis which accompanied this project. Determining a "fair value" is more straightforward when the economic environment is stable than during a liquidity crisis.

Despite these difficulties, the two Boards have succeeded in converging their definitions of fair value, which will henceforth be conceived in a consistent fashion in both sets of standards.

For the IASB, this standard is quite unusual, because it is its first standard focused on measurement rather than accounting treatment. The IASB is dipping a toe into an unaccustomed world. This step will probably be monitored closely by organisations in the valuation field. These include the IVSC (International Valuation Standards Council), which has so far declined to align its definition of fair value with that in IFRS 13.

Finally, this standard has given the IASB an opportunity to introduce a number of conceptual principles for fair value, or to reaffirm others which have been criticised. Two of these principles stand out in particular:

- An exit price approach, which may lead to practical difficulties when measuring some assets and liabilities upon initial recognition.
- An approach which determines fair value from the perspective of a market participant, as opposed to a measurement which takes account of the particularities and intentions of the entity holding the asset or liability in question.

We have published this guide to accompany your first steps in IFRS 13, whatever your level of expertise in valuation. We first explain the main concepts in IFRS 13 and illustrate how these concepts can pose problems using practical examples.

Secondly, we address the practical consequences of IFRS 13 as seen by our experts in actuarial studies, banking, real estate, valuation and insurance.

At the end of this guide, we conclude by summarising the ten key aspects of the standard.

The main principles of IFRS 13 "Fair Value Measurement"

1. WHAT IS THE EFFECTIVE DATE OF IFRS 13?

The standard IFRS 13 "Fair Value Measurement" was published by the IASB in May 2011. As far as the IASB is concerned, application will be mandatory to current reporting periods at 1 January 2013. Early application is authorised.

The application of IFRS 13 by the European entities is subject to its endorsement by the European Union.

At the time of writing, the endorsement process is under way. The ARC voted in favour of the adoption of IFRS 13 on 1 June 2012. The preliminary endorsement calendar published by EFRAG on its web site suggests that the standard will be adopted by the European Union during the fourth quarter of 2012. In the light of this timeframe, and subject to the vote of the European Commission, the mandatory application date for European entities may therefore coincide with the date set by the IASB.

Do not hesitate to consult the EFRAG site for updates:

http://www.efrag.org/Front/c1-306/Endorsement-Status-Report_EN.aspx

2. WHAT ARE THE TRANSITIONAL PROVISIONS OF IFRS 13?

IFRS 13 is to be applied prospectively as of the beginning of the annual reporting period in which it is initially applied.

No changes of values used for previous financial years will therefore be required. The provisions of IFRS 13 will only actually be applied with effect from 1 January 2013, even if the 2012 financial statements are presented for comparative purposes in the 2013 accounts.

Similarly, the disclosure requirements of IFRS 13 need not be applied to the comparative information presented for periods prior to the effective date.

NB: At the transition date, entities may potentially have to perform two valuations, the first one for the purposes of the closing of accounts up to the transition date, the second one to establish the opening balance for the period of transition. Let

us take the example of an entity finalising its annual accounts at 31 December and opting for 1 January 2013 as the date of first application. For an instrument measured at fair value, the entity must conduct:

- a first measurement in accordance with the provisions applicable before IFRS 13 comes into force, in order to finalise the accounts at 31 December 2012;
- a second measurement in accordance with IFRS 13 for the opening balance at 1 January 2013.

3. WHAT ARE THE OBJECTIVES OF IFRS 13?

IFRS 13 gives a single definition of fair value (i.e. applicable throughout the entire IFRS framework), and brings together all the information regarding fair value which must be provided in the notes.

In practice, IFRS 13 thus unites within a single standard the definitions and application guidance on fair value which were previously scattered across a range of standards.

IFRS 13 does not amend the scope of measurements at fair value in IFRSs; it does not discuss "when" to carry out fair value measurement, only "how" to do so.

The "when to apply fair value" issue remains within the scope of other IFRS standards. And whenever an IFRS requires fair value measurement, it will refer back to IFRS 13 for the measurement guidance.

4. WHAT ENTITIES ARE CONCERNED BY THE PROVISIONS OF IFRS 13?

All entities which publish their accounts under IFRSs are concerned by IFRS 13.

This can be illustrated by the example of a business combination: IFRS 3 requires the acquirer to measure all the assets and liabilities (financial and non-financial) of the acquired entity at fair value. We can therefore say that:

- all entities reporting under IFRSs may need to apply IFRS 13, regardless of their sector of activity;
- any asset or liability may have to be measured in accordance with the provisions of IFRS 13, be it only once.

Apart from IFRS 3, many other IFRSs use fair value, and thus will in future make reference to IFRS 13. Without claiming to be in any way exhaustive, these include IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment*, IAS 36 *Impairment of Assets*, IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 40 *Investment Property*, IAS 41 *Agriculture*, IFRS 5 *Non-current Assets held for Sale and Discontinued Operations* and IFRS 9 *Financial Instruments*.

5. MAY FAIR VALUE MEASUREMENTS REQUIRED BY IFRS STANDARDS BE EXCLUDED FROM THE SCOPE OF IFRS 13?

Yes.

Some situations are expressly excluded from the scope of IFRS 13.

IFRS 13 does not apply to:

- plan assets measured at fair value in accordance with IAS 19 *Employee Benefits*;
- retirement benefit plan investments measured at fair value in accordance with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*;
- assets for which recoverable amount is fair value less costs to sell in accordance with IAS 36 *Impairment of Assets*.

Finally, it must be stressed that IFRS 13 only applies when a standard requires a fair value measurement. So, IFRS 13 must not be applied when determining a "net realisable value" in accordance with IAS 2 *Inventories*, or a "value in use" in accordance with IAS 36 *Impairment of Assets*.

6. DOES IFRS 13 CONVERGE WITH THE US GAAP?

Yes, and this was among the main objectives of this project conducted jointly by the IASB and the FASB.

Some areas of divergence remain between IFRS 13 and its US GAAP equivalent, *Topic 820*. However, these are negligible if compared to the common principles which have now been adopted*.

7. WHAT IS THE NEW DEFINITION OF FAIR VALUE?

The definition of fair value before the publication of IFRS 13 was as follows**:

"Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

The new definition of fair value in IFRS 13 reads as follows:

"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".

If we compare these two definitions, we can immediately see that IFRS 13 introduces two significant changes:

- the primacy of the market: fair value is determined from the perspective of a "market participant" (question 8);
- exit price: fair value is the price to **sell** an asset or **transfer** a liability (question 10).

* *The remaining divergences relate to the application of fair value by investment entities as well as the measurement of financial liabilities with a demand feature (e.g. a demand deposit).*

** *Paragraph 9 of IAS 39*

8. WHAT DOES THIS CONCEPTUAL CHOICE OF A MARKET APPROACH ENTAIL?

Fair value must always be determined from the perspective of a "market participant"... who may not intend to use the element in the same way as the entity!

- Example: Entity A buys a competitor's trademark in the course of a business combination. To account for this business combination, A must measure the trademark at fair value. However, A does not intend to use the competing trademark. Nevertheless, a market participant would be prepared to pay to acquire and use this trademark. Consequently, A must measure (and recognise) this trademark at the price which the market participant would be prepared to pay, even though A is likely to have to impair the trademark at its next reporting date! *

Measurement as seen by a market participant is essentially opposed to a measurement specific to the entity. The current use of the element by the entity and its intentions as to future use are not taken into account in the IFRS 13 measurement guidance.

- Example: The entity acquired by entity A also possesses a vineyard in the heart of Paris in a buildable zone. The CEO of entity A, a great wine-lover, has no intention of closing down the vineyard. However, in measuring the value of this land under IFRS 13, no account will be taken of his intentions. It is much more likely that a market participant would measure this property at the price of a residential use. It will therefore be measured under IFRS 13 from a "residential use" perspective.

IFRS 13 thus requires the element to be measured based on the assumption that it will be exploited in its "highest and best use", regardless of the current use by the entity. Likewise, if a market price is used, IFRS 13 assumes that the transaction takes place in the *principal market* for the asset, even if the entity is normally active in another market (question 19).

** NB: this requirement was initially introduced in the standard IFRS 3.*

9. WHAT IF THERE IS NO MARKET FOR THE ASSET OR LIABILITY TO BE MEASURED?

IFRS 13 tells us to act as if a market existed!

As confusing as this may seem, the answer of IFRS 13 to this question is not without foundation. Leaving aside the practical difficulties inherent in this approach, the underlying idea of IFRS 13 is that assets and liabilities shall be measured from the perspective of a market participant, not that of the entity.

This approach thus implies:

- setting aside any considerations which are specific to the entity which a market participant would not take into account in determining fair value;
- taking into account all the information which the market participant would incorporate into his measurement approach, even where this information is irrelevant from the entity's perspective.

10. MUST RECENTLY ACQUIRED ITEMS BE MEASURED AT THE SALE PRICE?

Yes, because fair value is defined as an exit price. So one must apply the **sale** price of an asset, even if the valuation is being made at initial recognition of the asset in the statement of financial position.

The IASB considers that one participant's exit price is always another participant's entry price. If this is true in most circumstances, it may nevertheless present difficulties when different markets are involved.

⇦ Example: Some goods, such as vehicles, lose value immediately after their sale in the new market. Their subsequent resale can only take place in a different market, the second-hand market. This reasoning is also found in the financial world, where the distinction between the primary and secondary markets can lead to the same mechanisms. A participant in the primary market has no choice but to use secondary market prices to determine the fair value of the element it has just acquired.

11. WHAT ARE THE MAIN STEPS TO BE FOLLOWED IN THE IFRS 13 MEASUREMENT APPROACH?

The IFRS 13 approach addresses the following questions step-by-step:

- What is being measured (question 12)?
- What unit of account should be used (questions 13 and 14)?
- What is the "highest and best use" from the point of view of a market participant (questions 15 and 16)?
- What is the principal market (question 19)?
- What measurement technique should be used (question 21)?

12. TO WHAT EXTENT SHOULD WE TAKE ACCOUNT OF THE CHARACTERISTICS OF THE ASSET OR LIABILITY BEING MEASURED?

Account must be taken of all the characteristics and information regarding the asset or liability to be measured which a market participant would take into account, including:

- location (of land, inventories to include transport costs, etc.);
- condition (wear and tear, obsolescence, etc.);
- any restrictions on the use of the asset/liability.

Conversely, no account should be taken of factors which have no impact on its value from the perspective of a market participant, such as its colour if the latter does not affect use.

Special attention must be given to the distinction between the characteristics of the asset/liability being measured and those of the entity holding it!

For example, if it is not possible to build on a site, that is a characteristic of the land itself, and must be taken into account. However, a commitment by the entity not to build on this land, without obligation to transfer this commitment on sale, is instead a characteristic inherent in the entity rather than the asset, and should not be taken into account.

Similarly, transaction costs are entity-specific and must not be included in determining fair value.

13. WHAT IS THE UNIT OF ACCOUNT, AND HOW IS IT IMPORTANT?

The best way to illustrate this concept is to take an example.

- An entity is trying to determine the fair value of a set of shares and participating interests representing 15% of the capital of a listed entity. In this example, the unit of account is critical in measuring the share portfolio.
  - If the unit of account is the share of the entity taken individually, the value of the portfolio will simply be the sum of the value of one share multiplied by the number of shares held.
  - If the unit of account is the set of shares (i.e. the 15% taken together), adjustments may be applied, such as a control premium, or an illiquidity discount (the number of shares held is known to exceed the market capacity), etc.
- In this specific situation, IAS 39 requires the individual share to be used as the unit of account.

14. DOES IFRS 13 REQUIRE SPECIFIC UNITS OF ACCOUNT TO BE USED?

IFRS 13 refers to each specific standard to determine the unit of account to be used. Thus, in the illustration above, the unit of account required by IAS 39 should be applied*.

However, an exception to this principle may apply for certain financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk (question 27).

15. WHO IS THE "MARKET PARTICIPANT"?

In reality, it does not matter much. The standard states that it is not necessary to be able to identify the market participant, which is reassuring when no market is identified!

The market participant is therefore a concept for ensuring that the entity does not use measurement assumptions which are specific to it, rather than a physically identifiable participant.

** IFRS 9 should not change this requirement.*

IFRS 13 nevertheless states that the market participant is:

- independent (not a related party as defined in IAS 24);
- knowledgeable;
- capable of entering into a transaction for the asset or liability concerned;
- neither forced nor obliged to enter into a transaction for the asset or liability concerned.

16. WHAT IS THE "HIGHEST AND BEST USE"?

The "highest and best use" of an asset or liability corresponds to the use that would be made by a market participant acting in its economic best interest. A market participant thus intends:

- to use the asset or liability to maximise its economic interest;
- or to sell it to someone capable of doing so.

IFRS 13 stipulates that this may be any use at all, provided that it is:

- physically possible;
- legally permissible;
- and financially feasible (taking into account processing costs, etc.).

In general, the entity's current use of the asset will be presumed to be its "highest and best use".

However, if there is evidence to the contrary, i.e. proof that a market participant could maximise the asset's value through a better use, the entity will be obliged:

- to apply this alternative use when measuring the fair value of the asset or liability;
- to indicate in the disclosures the reasons for which it does not use the asset according to its "highest and best use".

17. WHAT SHOULD BE DONE IF THE "HIGHEST AND BEST USE" OF AN ASSET REQUIRES OTHER ASSETS OR LIABILITIES?

The "highest and best use" of an asset may consist of using it in combination with other complementary assets and associated liabilities.

- Example: semi-finished products which cannot be sold in this condition and which require specialised machinery for converting them into finished goods.

Under these circumstances, and for the purposes of measuring the fair value of the asset, it must be assumed that the market participant has access to these other assets and liabilities. This is therefore a measurement assumption which does not contradict the unit of account notion evoked in question 13.

Note! When the "highest and best use" of an asset consists of use in combination with other assets and/or liabilities, these assets and liabilities must be measured consistently. The measurement assumptions should thus be the same for all the assets and liabilities in this group enabling the "highest and best use".

18. ARE THERE ANY SPECIAL PROVISIONS FOR THE "HIGHEST AND BEST USE" OF FINANCIAL INSTRUMENTS?

Yes, IFRS 13 stipulates that this approach does not apply to financial instruments.

In practice, the sole use envisaged for financial instruments would therefore be their resale.

19. WHAT IS THE "PRINCIPAL MARKET"?

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

In the absence of a principal market, the most advantageous market should be used.

This means that IFRS 13 privileges market activity over price.

- If an active market proposes a value of 100 but the principal market proposes a value of 80, 80 is the value which will be applied.

The identification of the principal or most advantageous market is one of the rare parameters in fair value measurement which is, to a certain extent, specific to the entity. An entity must have access to the market applied for measurement. Consequently, two entities trying to measure the same asset or liability but with access to different markets could end up having two different "fair values".

In the absence of evidence to the contrary, it is assumed that the market in which the entity is or would be active is the principal market, or if not, the most advantageous market.

20. HOW SHOULD WE TAKE ACCOUNT OF A DECREASE IN MARKET ACTIVITY?

The IFRS 13 states that a significant decrease in the volume or level of activity in the market for an asset or a liability may affect the fair value of this asset or liability. Therefore, IFRS 13 proposes a series of criteria to be weighted together in order to determine whether activity in a market has fallen significantly.

A significant decrease in market activity does not indicate a priori that the market value no longer reflects the fair value of the asset or liability. A significant decrease in market activity must, however, give rise to additional analysis to determine whether the market price should be adjusted, or, more simply, whether the measurement technique should be changed (question 21).

The standard also sets out criteria for the identification of transactions which are not "orderly", and states that where such transactions are found, the price observed must be adjusted to bring them close to the price which would be paid in an orderly transaction.

21. WHAT VALUATION TECHNIQUES ARE PROPOSED?

IFRS 13 presents 3 categories of valuation techniques:

- the market approach, based on recent market transactions. This category includes, inter alia, techniques based on multiples;
- the "cost" approach, which reflects the cost of replacing the asset with another asset providing the same services;
- the income approach, which essentially consists of converting future cash flows into a single present (i.e. discounted) value.

All these approaches must be used with a single aim: determining the price from the perspective of a market participant at the measurement date.

Note that IFRS 13 does not demand the use of one or other of these methods on the basis of the circumstances or the type of asset or liability. However, it gives priority to the quality of inputs, stating that the entity must always use the valuation technique which maximises the use of observable market data.

22. WHAT IS THE FAIR VALUE HIERARCHY?

The IFRS 13 applies the input hierarchy already used in IFRS 7. The three levels are retained and defined as follows:

- Level 1 inputs: quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- Level 2 inputs: directly or indirectly observable inputs other than those included within Level 1.
  - Example: a Level 2 input will be a quoted price for a similar (but not identical) asset or liability, or a quoted price for an identical or similar asset or liability in markets that are not active.
- Level 3 inputs: all unobservable inputs for the asset or liability, including inputs that are specific to the entity.

Note that fair value hierarchy level depends on the lowest level input used in measurement.

- For example, if a valuation model uses three Level 1 inputs and one Level 3 input, the measurement will be considered as that of Level 3 overall

What is at stake in this fair value hierarchy is the quantity of disclosures to be provided. The lower the level of the fair value measurement of the asset or liability, the more disclosures about the valuation technique used are required.

23. HOW SHOULD ANY DIFFERENCES BETWEEN TRANSACTION PRICES AND FAIR VALUE BE TREATED UPON INITIAL RECOGNITION?

The contrast between entry price and exit price in IFRS 13 creates the risk of divergence between the transaction price and the initial fair value of an asset or liability in the statement of financial position.

Although the standard emphasises that in many cases the transaction price will be equal to fair value at initial recognition (in particular when the transaction takes place in a market in which the asset could be sold or the liability transferred), this will not always be the case in practice.

Where a standard requires an asset or liability to be measured at fair value at initial recognition and the transaction price is different, the difference is accounted for in profit or loss, unless otherwise specified in the applicable standards (as in the case of IFRS 3).

⇦ Note: for further discussion of the impact on the Day One Profit or Loss under IAS 39, please see question 34.

24. WHAT DOES THE "TRANSFER VALUE" OF A LIABILITY MEAN?

IFRS 13 speaks of the "transfer value" of a liability (financial or non-financial) in contrast to the amount payable to extinguish the liability. Thus, after the transfer, the liability remains outstanding and the transferee is required to fulfil the obligation. Similarly, in the case of an equity instrument (liability) it is assumed that the latter remains in circulation and that the acquirer takes on the rights and obligations.

Where no market exists for the transfer of the liability, but this instrument is an asset to a third party, it should be valued from the point of view of this third party. Price adjustment may nevertheless be necessary to take account of any differences in the characteristics of the instrument, depending on whether is it measured as an asset or a liability.

If necessary it is always possible to use other valuation techniques; for example a DCF method applied to estimates of flows payable as a result of the obligation.

- Note: in the case of transfer prices requiring the transferee to assume the entity's obligations, the fair value measurement should include the margin which would be demanded by a third party for the purposes of this transaction.

This approach remains subject to the IFRS 13 principle of applying the measurement techniques which maximise the use of observable inputs.

25. MUST THE FAIR VALUE OF A LIABILITY TAKE ACCOUNT OF THE NON-PERFORMANCE RISK? OR OWN CREDIT RISK?

Yes, IFRS 13 expressly states that the non-performance risk must be taken into account when using valuation techniques. This includes, but is not limited to, own credit risk.

The non-performance risk may be reflected either in future flows or in the discount rate.

- Take care not to include it twice!

26. FAIR VALUE AND DEMAND DEPOSITS: WHAT ARE THE MEASUREMENT SPECIFICITIES?

IFRS 13 indicates that the fair value of a financial liability with a demand feature (i.e. redeemable on first demand) is not less than the amount payable on demand.

This sum should be discounted if necessary from the first date that the amount could be required to be paid.

27. CAN ONE TAKE ACCOUNT OF THE NET FINANCIAL EXPOSURE WHEN MEASURING OFFSETTING RISK POSITIONS?

Yes, optionally (it is a matter of choice of accounting policy).

However, this approach can only be applied in certain cases:

- only for financial assets and liabilities (IAS 39 and IFRS 9);
- only in relation to market risks (interest rates, etc.) or to counterparty credit risk (e.g. taking into account master netting agreements, margin calls, etc.);
- only if this is consistent with the entity's management model and its internal reporting;
- only if all the financial assets and liabilities concerned are measured at fair value in the statement of financial position; and
- only if this offset is taken into account by a market participant in estimating the value of the portfolio.

Finally, IFRS 13 authorises this exceptional treatment on condition that the market risks borne by each component in the portfolio are substantially the same. For example, the risks borne by the asset and the liability must offset each other wholly or in part in order to be eligible.

⇦ Example: the standard indicates that in the event of a timing difference between a financial asset and a financial liability exposed to a similar risk, the entity should be able to determine the fair value of the portfolio:

- on a net exposure basis for the period in common;
- on a gross exposure basis for the residual period.

However, it is not necessarily possible to present offsetting financial assets and liabilities on a net basis in the statement of financial position. The unit of account rules under IAS 39 and the offsetting principles in IAS 32 continue to apply. IFRS 13 only addresses the question of measurement, not presentation.

Consequently, portfolio-level adjustments due to this netting effect must be allocated to the individual assets and liabilities concerned.

28. WHAT ARE THE MAJOR OBJECTIVES OF THE DISCLOSURES TO BE PROVIDED IN THE NOTES?

IFRS 13 states that the entity should provide disclosures enabling users of financial statements to assess:

- the valuation techniques and inputs used;
- for Level 3 measurements, the impact on the profit or loss account or the statement of comprehensive income of the assumptions applied in using unobservable inputs.

It should be noted that IFRS 13 contains a *minimum* list of disclosures. An entity may choose to provide more information if it believes that this will help to achieve the objective.

29. WITH IFRS 13, HAS THE DEFINITION OF "FAIR VALUE" BECOME UNIVERSAL?

No!

The IVSC (International Valuation Standards Council) identifies several types of valuation:

- *market value*: close to fair value in IFRS 13;
- *investment value*: value to the holder of the good;
- *fair value*: *"estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that properly reflects the respective interests of those parties"*. It is thus a value considered as fair by two identified parties and reflecting their respective interests.

Consequently, the IVSC's definition of fair value is different from that of IFRS 13.

So, should you go to an external provider (valuer, real estate expert, etc.) you will have to specify that you want an IFRS-proof fair value!

Expert perspectives: Actuarial team

30. WHAT IS AN "OBSERVABLE" INPUT FOR IFRS 13 PURPOSES, AND WHERE CAN YOU FIND IT?

For the purposes of measuring an asset or liability at fair value, IFRS 13 requires the use of a measurement technique which maximises the use of relevant observable inputs, while considering the complete set of characteristics of the asset or liability.

IFRS 13 defines "observable" inputs as *"inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability."*

The standard gives some examples of markets in which observable inputs can be identified:

- *exchange markets* (CAC 40, Eurostoxx, etc.): the prices observed derive directly from transactions and are generally representative of fair value;
- *dealer markets*: dealers are agents prepared to engage directly in buying and selling. Therefore, they provide a price at which they are willing to buy ("Bid") and a price at which they are willing to sell ("Ask"). They provide liquidity by trading on their own behalf;
- *brokered markets*: brokers are intermediaries who do not trade on their own account. Brokers match buyers and sellers to make the transaction possible. It is sometimes possible to obtain prices of completed transactions;
- *principal-to-principal markets*: transactions are negotiated independently with no intermediary and may therefore be used as observable inputs. However, limited information about these transactions is available publicly.

31. WHAT IS THE RELATIONSHIP BETWEEN THE INPUT DATA HIERARCHY AND THE CHOICE OF MEASUREMENT TECHNIQUE? MUST THIS BE A "STANDARD" TECHNIQUE?

As we have seen in question 21, IFRS 13 attributes more importance to the quality of the inputs than to the measurement model, which is chosen with a view to maximising the use of observable inputs.

IFRS 13 does not expressly require a "standard" model to be used in order for the measurement to be considered as Level 1 or 2.

However, it should be noted that the standard does require the use of a technique which is:

- appropriate;
- likely to be used by a market participant in estimating the price.

In our view, these two requirements mean that in practice the entity will use standard approaches whenever they are available.

32. WHAT NON-PERFORMANCE RISK SHOULD BE APPLIED WHEN MEASURING LIABILITIES: THE TRANSFEROR'S OR THE ACQUIRER'S?

Non-performance risk is the risk that an entity will not fulfil an obligation inherent in a liability. This risk includes the entity's own credit risk, as defined in IFRS 7.

Determining fair value in IFRS 13 relies on a theoretical transfer price between the entity holding the liability and the market participant: a priori, therefore, there is some ambiguity about which entity should fulfil the obligation.

To remove any doubt, the standard states that the risk to be taken into consideration for the purposes of fair value determination is that existing before the theoretical transfer.

Thus, in the case of a liability issued by entity A and hypothetically bought by market participant B, the non-performance risk to be taken into account is A's risk, and not that of the generally unidentified market participant B.

Expert perspectives: Banking sector

33. WHAT HAS IFRS 13 TO SAY ABOUT THE BID - ASK SPREAD?

IFRS 13 presents bid and ask prices as the outer limits of a price range within which fair value is determined.

The standard also indicates that the use of bid prices to measure an asset and ask prices to measure a liability is permitted but not required. Consequently, the standard recommends the use of the price within the bid - ask spread that is most representative of fair value.

The standard also acknowledges the possibility of using mid-market pricing as a practical expedient for fair value measures within the spread, in the absence of anything better.

34. DAY ONE PROFIT OR LOSS: WHAT WILL CHANGE?

As we saw at question 23, the opposition between entry price and exit price creates the risk of divergence between the transaction price and the initial fair value of an asset or liability.

For assets or liabilities initially recognised at fair value or using the fair value option, IFRS 13 states that the difference between the entry price and the fair value – the Day One Profit or Loss – should be recognised in profit or loss, unless otherwise specified in the specific standard applicable (IFRS 3, IAS 39, etc.).

IFRS 13 does not therefore amend the IAS 39 provisions for the recognition of Day One P&L.

Nonetheless, whenever the application of IFRS 13 has an impact on the fair value determination of an asset or liability on the initial recognition date, the Day One P&L may be affected automatically.

Expert perspectives: Real estate sector

35. IAS 40 VS. IFRS 13: WHAT ARE THE MAIN CHANGES?

Until now, the IAS 40 definition of the fair value of investment property excluded possible improvements to the asset: *"The fair value of investment property does not reflect future capital expenditure that will improve or enhance the property and does not reflect the related future benefits from this future expenditure."* (IAS 40 paragraph 51).

Only the elements existing at the measurement date were therefore taken into account when valuing investment property, and only repairs and maintenance expenditures could be reflected in the valuation.

IFRS 13 radically changes this approach, since the fair value of a non-financial asset must in future reflect the "highest and best use" which a market participant would make of it, and consequently all the costs involved in this optimal use.

From this perspective, the costs of refurbishment and transformation of investment property resulting in a change of use and maximising its valuation must be taken into account in the measurement approach chosen.

This approach will require valuers to use financial models enabling them to identify the "highest and best" use of the building - the use which will maximise the valuation of the asset.

36. "HIGHEST AND BEST USE": WHAT WILL BE THE IMPACT ON THE VALUATION OF INVESTMENT PROPERTY?

IFRS 13 states that *"A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use."* (IFRS 13 paragraph 27).

The limits set by the standard in defining this "highest and best use" are that the use must be physically possible, legally permissible and financially feasible.

In order to comply with IFRS 13, the valuation of investment property must no longer solely take account of the current use of the good, but also of its potential in the light of external information available to market participants. This potential should therefore be assessed in relation to the environment of the asset, including the local planning regulations and local development needs.

- For example, the "highest and best use" of a residential property in an area with an office shortage might well be the conversion of the property into an office building. Fair value measurement under IFRS 13 would then be based on the assumption of the transformation of the asset into an office building, provided that this conversion is feasible (physically possible, legally permissible and financially feasible). In this instance, the measurement will be based on the financial modelling of conversion costs and future income, taking into account this improvement of the building.

Applying this rule obliges real estate companies who have opted for fair value measurement to identify the "highest and best use" of their assets, in the light of local developments, each time the accounts are finalised. This principle should nevertheless be put into perspective: the standard states that *"an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset."* (IFRS 13 paragraph 29).

Therefore, in order to meet the conditions of IFRS 13, external valuers assessing the property of entities should justify the absence of evidence suggesting that the "highest and best use" (taking into account the stability of local planning regulations, local demand, etc.) might be different from the use made by the entity.

Expert perspectives: Transaction Services team

37. IS THE FAIR VALUE MEASUREMENT OF AN INTANGIBLE ASSET AFFECTED BY THE OTHER ASSETS REQUIRED FOR THE EXPLOITATION OF THE ASSET IN QUESTION?

This is a question of whether, for example, the fact that an industrial site manufacturing brand Z products is in severe overcapacity affects the value of brand Z.

IFRS 13 uses the idea of the "highest and best use" of the asset to justify taking no account of the issues of the sizing of production facilities for pricing the asset. The standard states that intangible assets must be measured on the assumption of better-calibrated production facilities, insofar as these facilities are accessible to market participants.

Production overcapacity is not a characteristic specific to the asset, but rather a feature of the entity which a market participant would not necessarily take into account when forming its assessment.

Consequently, this parameter will not be taken into account in the valuation.

38. IS IT POSSIBLE TO CHANGE THE MEASUREMENT APPROACH DURING THE RECURRENT VALUATION OF AN ASSET (E.G. IMPAIRMENT TESTS)?

Yes, but under conditions.

IFRS 13 recommends consistency in the choice of valuation techniques, but also states that a change of method may be appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

- For example, if a Level 1 fair value is available, it will not be possible to opt for another method which results in a measurement of an inferior level.

The standard also presents a non-exhaustive list of circumstances under which a change of measurement approach might be appropriate (paragraph 65):

- new markets develop;
- new information becomes available;
- market conditions change;
- valuation techniques improve;
- information previously used is no longer available.

Revisions of fair value resulting from a change in the valuation technique should be accounted for as a change in accounting estimate in accordance with IAS 8.

However, the disclosures in IAS 8 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique.

⇦ Reminder: IAS 36, which sets out the rules for impairment testing, states that the recoverable value of a cash generating unit is whichever is the higher of:

- value in use;
- fair value less costs to sell.

Of these two approaches, only "fair value less costs to sell" is amended by IFRS 13 (see question 5).

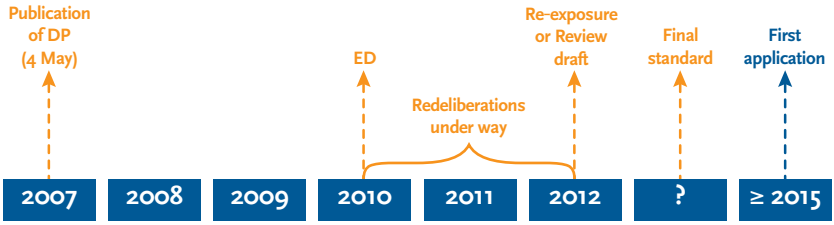
Expert perspectives: Insurance sector

39. WHAT ARE THE PRINCIPLE INTERACTIONS BETWEEN IFRS 4 AND IFRS 13?

IFRS 4 has been at the project stage for more than 10 years. The complexity of the subject and the significantly divergent opinions of stakeholders have delayed the finalisation of this standard on insurance contracts.

The first stage was completed in 2004 with the publication of standard IFRS 4 phase 1, which has been applied by listed entities in Europe since 2005. This consensual standard broadly enables insurers to maintain local accounting principles for insurance liabilities.

The second phase of the project is still in progress. Phase 2 is influenced by a number of draft standards, both accounting and regulatory.



During discussions on phase 2 of IFRS 4, the definition of an insurance liability has evolved from a transfer value (conceptually close to IFRS 13), in the 2007 Discussion Paper, to a liquidation value calibrated to the premium paid until the portfolio holder's liability is extinguished, in the exposure draft of 2010.

Since then, debates have continued on the structuring aspects of the project (consistency between the accounting treatment of assets and liabilities, volatility of results, etc.). **At the time of writing, the standard-setter does not appear to be in favour of measuring insurance liabilities at fair value.**

However, IFRS 13 contains no explicit exemption for insurance contracts. Therefore, IFRS 13 should be consulted for the fair value measurement of insurance contracts, for example in a business combination. In this instance, the interaction between

** Cette approche a été définie dans le cadre de l'exposé sondage publié en juillet 2010.*

IFRS 3R and IFRS 4 is explicitly set out in the existing standard. Paragraph 31 of IFRS 4 authorises insurers to use a presentation that splits the fair value of acquired insurance contracts into two components:

- a liability measured in accordance with the insurer's local accounting standards;
- an intangible asset reflecting the future margins of the portfolio.

The portfolio value would therefore be determined on the basis of fair value as calculated according to IFRS 13.

The arrival of phase 2 of IFRS 4 would not change this, since:

- even if insurance liabilities were no longer to be measured and accounted for in accordance with local standards, they would not be measured a priori under IFRS 13;
- the future standard also states that the value calibrated to liquidation until the extinguishing of the liability should be compared with fair value in the case of a business combination. The July 2010 exposure draft also sets out the treatment of the difference: if the fair value is higher than the "liquidation value", an additional residual margin is recorded as a liability. In the opposite case, the acquirer will account for the difference as a supplement to goodwill.

In conclusion, at the time of writing we believe that the interaction between IFRS 4 and IFRS 13 will be limited to the case of business combinations mentioned above.

Remember the key points!

40. WHAT ARE THE 10 KEY POINTS OF IFRS 13?

1. **Effective date:** as far as the IASB is concerned, annual periods beginning on or after 1 January 2013. At the time of writing, the European endorsement process is in line with this timetable.
2. **Scope:** whenever a particular standard requires an asset or liability to be measured at "fair value". Consequently, there is no extension of the scope of fair value. IFRS 13 explains "how" to carry out fair value measurement, not "when".
3. **All entities are affected**, even if only by the provisions of IFRS 3 which require the acquiree's assets or liabilities to be measured at fair value in a business combination.
4. **New definition of fair value:** *"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".*
5. **Fair value is an exit price**, even when the asset or liability is measured in the statement of financial position upon initial recognition. If the transaction price differs from fair value at initial recognition, the difference is accounted for in profit or loss, unless otherwise specified in the applicable standards.
6. **Fair value is determined from the perspective of a market participant**, which excludes any valuation specific to the entity.
7. **The asset or liability must be measured at its "highest and best use"**, which may be different from the use currently made by the entity.
8. **Fair value is the transaction price observed in the principal market for the asset** to which the entity has access, even if it habitually trades in another more advantageous market.
9. **There is a three-level fair value hierarchy inspired by IFRS 7**. It is based on the level of inputs and not on the valuation technique used. The lower the fair value level, the greater the requirements for disclosures.
10. **Although IFRS and US GAAP fair value measurement requirements have been aligned, their definition of fair value is not universal.** The IVSC (the International Valuation Standards Council) uses a different definition of fair value. Beware of confusion if a third party carries out the valuation!

Notes

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