IFRS EDUCATION SERIES

Fair Value Measurement

IFRS 13

B D CHATTERJEE

FCA, ACMA, ACS, DipIFR (ACCA) – United Kingdom

ROADMAP

Contents

A structured walk-through of fair value concepts, valuation techniques, the input hierarchy and disclosure requirements under IFRS 13

PART I

Foundations

What fair value means, entry and exit price, market participants, and the principal market

CORE DEFINITION

What Is Fair Value?

DEFINITION – IFRS 13

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

An Exit Price

Fair value is a market-based exit price, not an entity-specific entry price or a value in use

Measurement-Date Specific

It reflects market conditions and participant assumptions at the measurement date, not at inception or a past date

CORE DEFINITION

What Is an Orderly Transaction?

DEFINITION

A transaction that assumes exposure to the market for a period before the measurement date, to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. It is not a forced transaction – for example, a forced liquidation or a distress sale.

WHY IT MATTERS

Fair value assumes a willing, unpressured transaction – prices from a fire sale or liquidation are not evidence of fair value under IFRS 13.

COMPARISON

Entry Price vs. Exit Price

Entry Price	Exit Price
The price paid to acquire an asset, or received to assume a liability, in an exchange transaction.	The price that would be received to sell an asset, or paid to transfer a liability – this is the fair value concept used by IFRS 13.

WHO SETS THE PRICE

Market Participants

Buyers and sellers in the principal (or most advantageous) market who have all of the following characteristics:

A **Independent** not related parties as defined in IAS 24, though a related-party price may be used as an input if there is evidence it was at market terms

B **Knowledgeable** a reasonable understanding of the asset or liability, using all available information including usual and customary due diligence

C **Able to Transact** capable of entering into a transaction for the asset or liability

D **Willing** motivated to transact, but not forced or otherwise compelled to do so

MARKET SELECTION

Principal and Most Advantageous Markets

Principal Market

The market with the greatest volume and level of activity for the asset or liability. Fair value is measured using the price in this market, assuming access to it.

Most Advantageous Market

In the absence of a principal market, the market that maximises the amount receivable for an asset, or minimises the amount payable to transfer a liability, net of transaction and transport costs.

PART II

Valuation Techniques

The market, cost and income approaches, and the present value technique used to estimate fair value

OVERVIEW

Three Valuation Approaches

IFRS 13 requires the use of valuation techniques consistent with one or more of the following approaches, maximising relevant observable inputs.

Market Approach

Uses prices and information from market transactions involving identical or comparable assets, liabilities, or a group of assets and liabilities

Cost Approach

Reflects the amount currently required to replace the service capacity of an asset (current replacement cost)

Income Approach

Converts future amounts, such as cash flows or income, to a single current discounted amount

APPROACH 1

Market Approach

- Uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities such as a business
- Valuation techniques consistent with this approach often use market multiples derived from a set of comparables
- Multiples may fall within a range, with a different multiple for each comparable – selecting the appropriate multiple requires judgment based on qualitative and quantitative factors specific to the measurement
- Matrix pricing is a related technique, used principally to value debt securities by reference to their relationship to benchmark quoted securities rather than quoted prices for the specific security

APPROACH 2

Cost Approach

DEFINITION

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset – often referred to as current replacement cost.

APPROACH 3

Income Approach

Converts future amounts (cash flows, or income and expenses) to a single current discounted amount, reflecting current market expectations.

Present Value Techniques

Discount projected future cash flows to a current value using a market-based discount rate

Option Pricing Models

Black-Scholes-Merton or binomial (lattice) models, which incorporate present value techniques and reflect both time and intrinsic value

Multi-Period Excess Earnings

Used to measure the fair value of certain intangible assets by isolating the earnings attributable to that asset

Elements a Fair Value Measurement Must Capture

From the perspective of market participants at the measurement date, a present value technique captures:

1. **Estimated future cash flows** for the asset or liability being measured
2. **Expectations about variability** possible variations in the amount and timing of the cash flows, reflecting inherent uncertainty
3. **Time value of money** the risk-free rate on monetary assets with maturities matching the cash flow period, with no timing uncertainty or default risk
4. **Risk premium** the price for bearing the uncertainty inherent in the cash flows
5. **Non-performance risk** for a liability, including the entity's own credit risk, plus any other factors market participants would consider

General Principles

Cash flows and discount rates must be internally consistent, reflecting only the assumptions market participants would use:

- Cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability, taking into account only factors attributable to it
- Discount rates should reflect assumptions consistent with those inherent in the cash flows, avoiding double-counting or omitting risk factors
- Nominal cash flows (including inflation) are discounted at a nominal rate; real cash flows (excluding inflation) are discounted at a real rate
- After-tax cash flows are discounted at an after-tax rate; pre-tax cash flows at a rate consistent with those cash flows
- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated

PART III

Fair Value Hierarchy

Level 1, 2 and 3 inputs, and the distinction between observable and unobservable data

INPUT HIERARCHY

Three Levels of Inputs

IFRS 13 establishes a fair value hierarchy that categorises valuation inputs into three levels:

Level 1

Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date

Level 2

Inputs other than Level 1 quoted prices that are observable for the asset or liability, either directly or indirectly

Level 3

Unobservable inputs, used to the extent relevant observable inputs are not available

COMPARISON

Observable vs. Unobservable Inputs

Observable Inputs	Unobservable Inputs
Developed using market data, such as publicly available information about actual events or transactions, reflecting the assumptions market participants would use when pricing the asset or liability.	Inputs for which market data are not available, developed using the best information available about the assumptions market participants would use when pricing the asset or liability.

DISTINGUISHING CONCEPT

Participant-Specific Value

DEFINITION

The estimated value of an asset or liability considering specific advantages or disadvantages of the owner, an identified acquirer, or identified participants – factors that may not be applicable to market participants in general.

EXAMPLE

A participant-specific value for a potential acquirer of a manufacturing facility might reflect location- or business-specific synergies unique to that acquirer – advantages not available to market participants generally, and therefore excluded from fair value.

SCOPE EXCLUSION

Transaction Costs

Costs to sell an asset or transfer a liability in the principal (or most advantageous) market, directly attributable to the disposal or transfer, meeting both criteria below:

A **Direct and essential** the costs result directly from, and are essential to, that transaction

B **Avoidable** the costs would not have been incurred had the decision to sell the asset or transfer the liability not been made – similar to costs to sell as defined in IFRS 5

KEY POINT

Transaction costs are not included in the fair value measurement of the asset or liability itself – they are accounted for separately in accordance with other applicable standards.

PART IV

Applying the Standard

The six-step process for determining fair value using a valuation technique

PROCESS

Six Steps to Determine Fair Value

1. **Determine the unit of account** identify the asset, liability, or group being measured
2. **Evaluate the valuation premise** for non-financial assets, determine highest and best use – in-use or in-exchange
3. **Assess the principal market** identify the market with the greatest volume and level of activity
4. **Determine the most advantageous market** where there is no principal market
5. **Select the valuation technique** market, cost, or income approach, or a combination
6. **Determine fair value** applying the selected technique and the appropriate hierarchy inputs

PART V

Disclosure Requirements

What entities must disclose for recurring and non-recurring fair value measurements

OBJECTIVE

What Disclosures Must Achieve

An entity discloses information that helps users of its financial statements assess:

A **Valuation basis** for assets and liabilities measured at fair value on a recurring or non-recurring basis, the valuation techniques and inputs used

B **Level 3 impact** for recurring measurements using significant unobservable inputs, the effect on profit or loss or other comprehensive income for the period

IF INSUFFICIENT

If disclosures under this and other IFRSs are insufficient to meet these objectives, the entity discloses whatever additional information is necessary to meet them.

MINIMUM DISCLOSURES

For Each Class of Assets and Liabilities

At a minimum, disclose the following for each class measured at fair value after initial recognition:

- a **Fair value at period end** and, for non-recurring measurements, the reasons for the measurement
- b **Hierarchy level** the level (1, 2 or 3) within which the measurement is categorised in its entirety
- c **Level 1–Level 2 transfers** amounts, reasons, and the entity's policy for determining when transfers occurred, disclosed separately for transfers in and out
- d **Valuation technique and inputs** for Level 2 and 3 measurements, including any change in technique and the reason for it

LEVEL 3 DISCLOSURES

Reconciliation of Opening to Closing Balances

For recurring Level 3 measurements, a reconciliation disclosing changes during the period attributable to:

i **Gains/losses in profit or loss** total for the period, and the line item(s) in which they are recognised

ii **Gains/losses in OCI** total for the period, and the line item(s) in which they are recognised

iii **Purchases, sales, issues, settlements** each type of change disclosed separately

iv **Transfers into or out of Level 3** amounts, reasons, and the entity's transfer policy, disclosed separately for transfers in and out

LEVEL 3 DISCLOSURES

Additional Requirements

- The amount of unrealised gains or losses for the period, relating to assets and liabilities still held at the reporting date, and where they are recognised in profit or loss
- A description of the valuation processes used, including how the entity decides its valuation policies and procedures and analyses period-to-period changes
- A narrative description of sensitivity to changes in unobservable inputs, where a change could result in a significantly higher or lower measurement
- For financial instruments, the effect of changing one or more unobservable inputs to reasonably possible alternative assumptions, if the effect on fair value would be significant
- If the highest and best use of a non-financial asset differs from its current use, that fact, and why it is being used differently

SUMMARY

Key Takeaways

Fair Value Is an Exit Price

Market-based, not entity-specific, and measured at a specific date

Principal Market Governs

Use the most advantageous market only where there is no principal market

Three Approaches

Market, cost and income approaches, maximising observable inputs

Three-Level Hierarchy

Level 1 quoted prices down to Level 3 unobservable inputs

Transaction Costs Excluded

Not part of the fair value measurement itself

Level 3 Needs the Most Disclosure

Reconciliation, sensitivity and valuation process disclosures apply

ABOUT THE AUTHOR

A Career Built on Making IFRS Understandable

BD

B D Chatterjee

FCA · ACMA · ACS · DipIFR (ACCA UK)

Teacher and Mentor to finance professionals worldwide

B D Chatterjee is a Chartered Accountant and financial thought leader with over 35 years of global experience spanning corporate finance, accounting standards, financial reporting, business valuation and financial due diligence. As a seasoned CFO, he has led finance functions across major corporations and now heads Digital CFO Solutions, a platform delivering institutional-grade IFRS, US GAAP and valuation workbooks alongside fractional CFO services.

Published Author

Author of the Pocketbook of IFRS series and other finance titles.

Guided Thousands

Through IFRS, US GAAP and valuation transitions worldwide.

Institutional-Grade Platforms

Excel-based CFO workbooks used by finance teams globally.

Digital CFO Solutions

Institutional-grade workbooks, fractional CFO advisory, and published finance literature.

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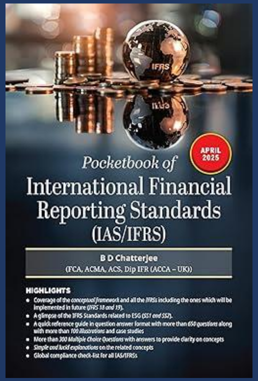

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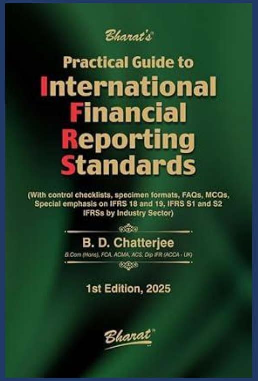
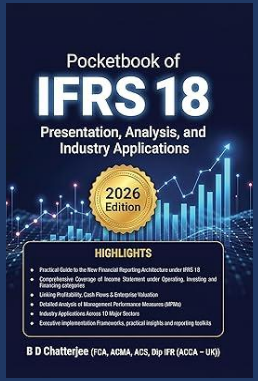


Practical Guide to International Financial Reporting Standards



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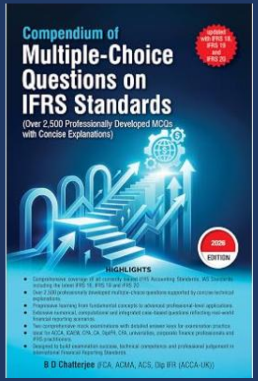

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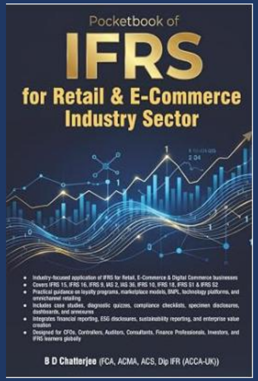

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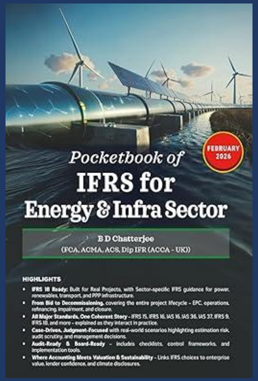

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