



IFRS Adviser Alert

Insights into IFRS 13 – Fair Value Measurement

July 2021

Executive summary

The Grant Thornton International IFRS team has published *Insights into IFRS 13 – Fair Value Measurement*.

IFRS 13 *Fair Value Measurement* explains how to measure fair value by providing clear definitions and introducing a single set of requirements for almost all fair value measurements. It clarifies how to measure fair value when a market becomes less active. IFRS 13 applies to both financial and non-financial items but does not address or change the requirements on when fair value should be used.

The publication *Insights into IFRS 13* not only summarises the standard, it also provides detailed commentary on various aspects of applying IFRS 13 from the perspective of a preparer working alongside a valuation expert.

Resource

The publication *Insights into IFRS 13 – Fair Value Measurement* follows this *IFRS Adviser Alert*.



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Insights into IFRS 13

Fair Value Measurement



Fair Value Measurement

IFRS 13 ‘Fair Value Measurement’ explains how to measure fair value by providing clear definitions and introducing a single set of requirements for almost all fair value measurements. It clarifies how to measure fair value when a market becomes less active. IFRS 13 applies to both financial and non-financial items but does not address or change the requirements on when fair value should be used.

IFRS 13 has been effective since 1 January 2013 and was subject to a Post Implementation Review (PIR) in 2017. As a result of this PIR, the International Accounting Standards Board (IASB) concluded that IFRS 13 is working as intended. Specifically,

- the information required by IFRS 13 is useful to users of financial statements
- some areas of IFRS 13 present implementation challenges, mainly in areas requiring judgement. However, evidence suggests that practice is developing to resolve these challenges, and
- no unexpected costs have arisen from application of IFRS 13.

The IASB therefore concluded no changes were required to IFRS 13.






This Insights into IFRS 13 article not only summarises the Standard, it also provides detailed commentary on various aspects of applying this Standard from the perspective of a preparer working alongside a valuation expert.

“IFRS 13 ‘Fair Value Measurement’ explains how to measure fair value by providing clear definitions and introducing a single set of requirements for almost all fair value measurements.”

Summary of IFRS 13

Fair Value Measurement

The table summarises the main requirements of the Standard:

| Requirement | Significance |
|--|--|
|  Scope | <ul style="list-style-type: none"> addresses all fair value and 'fair value-based' measurements (except those in IFRS 2 'Share-based Payment' and IFRS 16 'Leases') covers both financial and non-financial items fair values that are required to be disclosed in the notes are also captured. |
|  Definition of fair value | <ul style="list-style-type: none"> an exit value-based approach emphasis on market participants excludes entity specific factors a transaction or entry price may not necessarily represent fair value eg where related parties are involved or a transaction takes place under duress. |
|  Fair value measurement approach | <ul style="list-style-type: none"> transactions are assumed to take place in the principal (or most advantageous) market for non-financial assets, the highest and best use of the asset is considered guidance is provided for measuring the fair value of a liability in the absence of an active market for the liability adjustments for premiums and discounts must be consistent with the unit of account, blockage. |
|  Valuation techniques | <ul style="list-style-type: none"> entities are required to maximise the use of relevant observable inputs and minimise the use of unobservable inputs a three-level fair value hierarchy gives the highest priority to quoted prices in active markets and lowest priority to unobservable inputs (Level 3 inputs). |
|  Disclosures | <ul style="list-style-type: none"> fair value hierarchy disclosures are required for financial and non-financial items and also items not measured at fair value but for which fair value is disclosed disclosure requirements are proportionally greater for Level 3 fair value measurements. |

Scope of the Standard

IFRS 13 applies when another IFRS requires or permits fair value measurements – either in the primary statements themselves or in the footnotes (including ‘fair value-based’ measurements). In other words, it explains how to measure fair value rather than when to.

In addition to items measured at fair value in the primary statements, IFRS 13 also applies to items that are fair valued for disclosure purposes only. Examples include the fair value disclosure requirements in IFRS 7 ‘Financial Instruments: Disclosures’, and those in IAS 40 ‘Investment Property’ when the cost model is applied.

IFRS 13 does not however apply to:

- transactions within the scope of IFRS 2 or IFRS 16, or
- measurements that have some similarity to fair value but are not fair value (eg net realisable value in IAS 2 ‘Inventories’ and value in use in IAS 36 ‘Impairment of Assets’).

“In addition to items measured at fair value in the primary statements, IFRS 13 also applies to items that are fair valued for disclosure purposes only.”

Examples of fair value measurement within the scope of IFRS 13

| IFRS Standard | Required | Permitted | Details |
|---|----------|-----------|---|
| IFRS 3 'Business Combinations' | ✓ | | Acquisition-date fair value of consideration transferred and of most assets and liabilities acquired |
| IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' | ✓ | | Use of fair value less costs to sell* for non-current assets held for sale and disposal groups |
| IAS 16 'Property, Plant and Equipment' | | ✓ | Option to revalue property, plant and equipment at fair value |
| IAS 19 'Employee Benefits' | ✓ | | Defined benefit plan assets are measured at fair value |
| IAS 27 'Separate Financial Statements', IAS 28 'Investments in Associates and Joint Ventures' and IFRS 11 'Joint Operations' | | ✓ | Option to measure investments in subsidiaries, associates or jointly controlled entities at fair value |
| IAS 36 'Impairment of Assets' | ✓ | | Use of fair value less costs to sell* when necessary to establish recoverable amount |
| IAS 38 'Intangible Assets' | | ✓ | Option to revalue intangible assets (in limited circumstances) |
| IFRS 9 'Financial Instruments' | ✓ | ✓ | Use of fair value depends on the type of financial instrument |
| IFRS 17 'Insurance Contracts' | ✓ | ✓ | Contracts within the scope of IFRS 17 are not excluded from the scope of IFRS 13. However, IFRS 17 does not generally require fair value measurement except on transition in certain circumstances. |
| IAS 40 'Investment Property' | | ✓ | Option to value investment property at fair value |
| IAS 41 'Agriculture' | ✓ | | Biological assets and agricultural produce are measured at fair value |

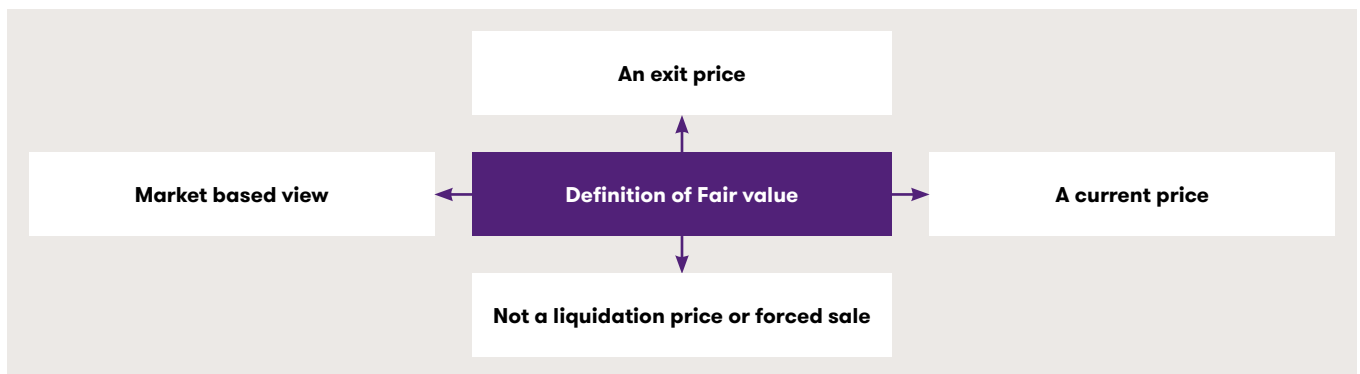
* fair value less costs to sell is an example of a 'fair value-based' measurement.

Definition of Fair Value

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”.

A number of concepts are embodied in the definition. Firstly, it clarifies that fair value is an ‘exit’ price – for example, it refers to the transfer of a liability rather than settlement. Secondly, it assumes an orderly sale or transfer (ie not a forced transaction or a distressed sale). Thirdly, there is an explicit reference to ‘market participants’, emphasising that fair value is a market-based concept. Finally, IFRS 13 clarifies that fair value is a current price at the measurement date (eg the acquisition date in a business combination, or the period end for a recurring fair value measurement).





Transaction prices and 'day one' fair values

IFRS 13 indicates that a transaction price (eg the price paid to acquire an asset) often equals the initial or 'day one' fair value. However, this is not presumed to be the case. This is particularly relevant to financial assets and liabilities as IFRS 9 'Financial Instruments' included such a presumption (which was rebuttable only in strictly limited circumstances). It is also applicable when assessing IFRS 17 'Insurance Contracts'.

Examples of situations where a transaction price may not equal day one fair value include transactions:

- between related parties
- entered into under duress or forced circumstances (eg where the seller is experiencing severe financial difficulty)
- in a large block of identical items (eg shares) but where the unit of account is each individual item, and
- in a market that is not the principal (or most advantageous) market.

In such situations entities may need to use valuation techniques to determine day one fair value, resulting in a difference between this and the transaction price. This difference will affect profit or loss unless another IFRS requires a different treatment (eg deferral or capitalisation). For financial assets and liabilities, IFRS 9 require these differences to be deferred in many cases.

Even when day one fair value equals the transaction price, IFRS 13 requires a calibration of the valuation technique if it uses unobservable inputs and the item will be fair valued going forward.

For example, if the valuer intends to use an income approach or market approach to estimate the fair value, the same approach should be applied at the transaction date to ensure that the unobservable inputs are consistent with the price paid. This helps to benchmark judgements such as:

- discount rates in an income approach, by calculating the implied internal rate of return (IRR) at the transaction date, or
- discounts/premia to peer group multiples in a market approach.

IFRS 13's guidance in this area should be considered in conjunction with its requirements on bid-ask spreads (see subsequent discussion) on page 14.



Working with valuation specialists

Entities that use external valuation specialists to assist in estimating fair values will need to ensure the bases and methods used comply with IFRS 13.

The term 'fair value' is used in professional valuation standards but its definition may differ to IFRS 13. For example, International Valuation Standards (IVS) 104: Bases of Value defines various related concepts such as fair value, market value and fair market value, which may take into account factors such as synergistic value. IFRS 13's definition is generally more consistent with the IVS concept of 'market value', which is

"... the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion."

Despite differences in terminology, applying a market participant perspective is very familiar to professional valuers, as are many of the other concepts and techniques in IFRS 13 (such as the 'highest and best use' concept).

That said, IFRS 13 does include some principles and requirements that may be less familiar, or not intuitive, to a professional valuer. These include requirements that are primarily accounting concepts rather than valuation matters. Management therefore needs to ensure the valuation expert is instructed in sufficient detail to ensure clarity and a common understanding of what is required for financial reporting purposes.

Examples of such areas to consider in this respect could, depending on the circumstances, include:

- specifying the items for which a fair value is required – for example in a business combination the assets and liabilities that meet IFRS 3's recognition requirements
- unit of account issues – put simply, whether the valuation is of a single asset or liability, or a group of items such as a cash-generating unit
- the characteristics of the asset or liability to be taken into account in the valuation – such as when restrictions on use or sale are relevant
- the reference market – for example identifying the market(s) that are accessible or inaccessible to the entity as well as the market normally used the need for valuations to be supported by more observable, quantitative evidence than may have been the case in the past, and
- when a valuation should incorporate a consideration of potential alternative uses for assets including the effects of non-performance risk when valuing liabilities.

In summary, the key to working effectively with valuation experts is timely, clear communication to ensure all parties have the relevant information to perform the valuation. Management is of course ultimately responsible for the amounts in the financial statements and ensuring they are IFRS 13 compliant.

The fair value measurement approach in IFRS 13

Having established the basic context in which fair value is to be determined, IFRS 13 then considers:

- the characteristics of the asset or liability
- the market in which the transaction is assumed to take place (reference market)
- the application to non-financial assets, and
- the application to liabilities and own equity.

The characteristics of the asset or liability

A valuation will differ depending on which characteristics of an asset or liability are taken into consideration – for example condition, location and restrictions on use or sale. The concept in IFRS 13 is that these types of factor are taken into account in fair value estimates if they are (i) a characteristic of the asset or liability in question (rather than a characteristic of the entity that holds the item); and (ii) they would influence market participants’ pricing decisions.

In the case of restrictions on sale of an asset (including so-called ‘lock-in’ restrictions), a critical factor to consider is whether market participants would be faced with the same restriction if they acquired the asset. This in turn depends on whether the restriction is part of the asset’s contractual terms or arises from a separate, entity-specific agreement.

By contrast, when fair valuing a liability, IFRS 13 prohibits any adjustments for restrictions that prevent transfer. This is noteworthy as such restrictions are a feature of many liabilities.

The following table illustrates how this guidance applies in practice:

| Situation | Impacts Fair Value |
|---|--------------------|
| Entity holds equity shares (financial asset) and has agreed with another entity not to sell for at least 12 months | No |
| Charity holds land donated for use only as a playground but which could be sold to raise funds and the restriction would not transfer to the buyer | No |
| Entity holds a piece of land that is subject to an enduring legal right enabling a utility company to run power cables across the land | Yes |

In each of the three scenarios, the restriction impacts fair value only where market participants would be affected by it.



Transport and transaction costs

IFRS 13 takes the view that transaction costs (eg the commission that would be charged by a selling agent) are not a characteristic of an asset or liability and do not therefore affect fair value.

By contrast, transport costs are relevant to fair value if location is a characteristic of an asset. This may be the case for physical assets, for example, if the principal or most advantageous market (see page 10) is an export market, and for commodities that are valued using benchmark prices that are location-specific.

The reference market

IFRS 13's emphasis on a market-based view raises questions as to which market should be referenced if more than one exists in the asset or liability in question (the 'reference market' concept). IFRS 13 assumes the transaction to sell the asset or transfer the liability takes place in the principal market or, in the absence of a principal market, in the most advantageous market.

The principal market is the market with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market that maximises the amount that would be received to sell the asset or paid to transfer the liability, after considering transaction and transport costs. It should be noted the most advantageous market does not always result in the highest fair value because fair value excludes transaction costs.

The IASB's belief is that in most cases the principal market will also be the most advantageous market, and will also be the market the entity would actually use. Entities do not therefore need to undertake an exhaustive search of all possible markets but are required to take into account all information that is reasonably available.



The reference market

In applying IFRS 13's guidance on the reference market, entities should consider:

The market it actually uses

In the absence of evidence to the contrary, the market in which an entity would normally enter into a transaction (to sell the asset or to transfer the liability) is presumed to be the principal market or, in the absence of a principal market, the most advantageous market.

Access to particular markets

A market that is not accessible to the entity cannot be used as the reference market, so the principal or most advantageous market is identified from those markets that are accessible. Where a company is listed on multiple stock exchanges, differences in liquidity and pricing may impact the market in which a shareholder chooses to transact. Alternatively, in valuing a derivative a bank that trades in such instruments might look to the dealer (inter-bank) market, whereas a commercial entity is unlikely to have access to that market.

If there is not an observable market for an entity in a specific country, entities can benchmark/reference to the next closest observable market. For example, if valuing an asset or liability in Cambodia, where there is not really an observable/reliable market, one can look to the wider observable and liquid markets in and around the vicinity of Cambodia – in this case, Asia.

The existence of an observable market

Many assets and liabilities that are fair valued are rarely (sometimes never) bought and sold, instead are bought and sold only as part of a larger transaction such as a business combination. Indeed, many liabilities include restrictions that prevent their transfer. In such cases, the entity is still required to take a 'market participant perspective' but the reference market is a hypothetical one. For example, in valuing customer-related intangibles in a business combination the acquirer (normally through the use of a valuer) should consider the types of potential market participants (eg competitors) and aim to make assumptions that are consistent with their perspective.



Guidance on inactive markets

IFRS 13 includes a definition of ‘active market’ and guidance on how to assess whether market activity has significantly decreased. This is mainly relevant for financial assets that are traded and for which quoted prices are available. If the market is ‘active’ as defined, the quoted price is classified as a Level 1 input (see guidance on fair value hierarchy on page 16) and must be used as the fair value. If trading volume on a market is very low or has declined significantly a quoted price may need to be adjusted or even supplanted by a valuation technique. Examples include stocks listed on exchanges such as AIM in London, which tend to be less liquid than those on the FTSE, or market shocks which impact liquidity on larger exchanges. During 2020, global lockdowns in response to COVID-19 resulted in a decrease in liquidity in corporate debt markets.

IFRS 13 sets out a number of factors to consider in determining whether there has been such a decrease, while noting that a decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly.

Guidance is then provided to help identify transactions that are not orderly.

Circumstances noted in the Standard that may indicate that a transaction price is not orderly, include the following:

- there was not adequate exposure to the market to allow for the usual level of marketing activities
- there was a usual and customary marketing period, but the asset or liability was marketed to a single market participant
- a distressed sale (ie the seller is in or near bankruptcy or receivership)
- a forced sale (eg the seller was required to sell to meet regulatory or legal requirements), and
- the transaction price is an outlier when compared with other recent transactions.

Where a transaction is not orderly, an adjustment to observed transaction prices or another valuation technique may be necessary to measure fair value.



Highest and best use

The inputs to a valuation technique may differ depending on how a non-financial asset is assumed to be used. Because IFRS 13 measures fair value from the perspective of market participants, an asset’s current use by its owner may not be relevant if other market participants would use the asset differently. An intangible asset may, for example, provide defensive value (protecting its competitive position) because the acquirer holds the asset to keep it from being used by competitors. For example, if a well-known consumer brand is acquired by a competitor and subsequently rebranded, the original brand may still hold value to another market participant if they were allowed to acquire it instead. The defensive value of the intangible asset would not be relevant to the calculation of the asset’s fair value, however, unless other market participants would use the asset in the same way.

IFRS 13 does not however require an entity to perform an exhaustive search (one which is performed comprehensively and completely) 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. However, the entity should consider a reasonable amount of potential use scenarios. ‘Reasonable’ meaning the most realistic potential uses if there are any, and the scenarios should cover the most sensitive elements of the valuation.

The highest and best use principle should be applied in conjunction with the guidance on the most advantageous market, and also the valuation premise. The interactions between assets also need to be evaluated. For example, in valuing land with an industrial building, an alternative use for the ‘bare’ land may yield a higher value. This would however imply a zero value for the building. When the land and building are considered together the combined value may be higher based on current use. In that case the current use is the highest and best use.

Application to non-financial assets

IFRS 13 states that a fair value measurement of a non-financial asset takes into account the highest and best use of the asset. The highest and best use of a non-financial asset must be:

- physically possible
- legally permissible, and
- financially feasible.

In the majority of cases, the concept of highest and best use is not relevant to financial assets because such assets have specific contractual terms and therefore do not have alternative uses (a different use would only be possible if the characteristics of the financial asset were to be changed). However, there are some financial assets where the contractual terms allow for multiple decisions which should be considered. It is also not relevant to liabilities.



Valuation premise for non-financial assets

The highest and best use of a non-financial asset establishes how its fair value should be measured (the 'valuation premise') in terms of whether it should be valued on a stand-alone basis or as a group in combination with other assets (or other assets and liabilities).

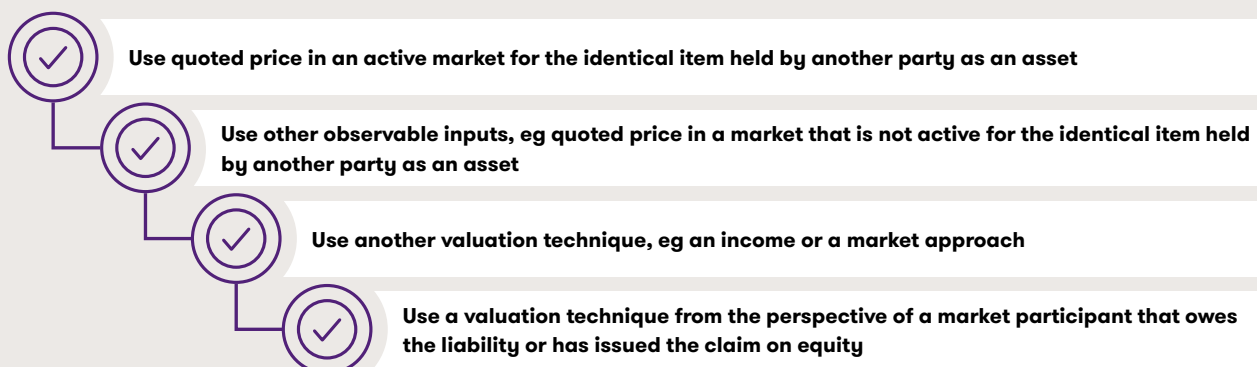
Where the resulting fair value measurement assumes the highest and best use of the asset is to use it in combination with other assets or with other assets and liabilities, it is assumed the market participant already holds those complementary assets and associated liabilities. This assumption is necessary as, without it, IFRS 13's exit value approach might lead to valuing some highly specialised assets and items such as work-in-progress on a scrap basis.

Application to liabilities and own equity

Measuring fair value can be problematic for liabilities and an entity's own equity instruments due to quoted prices for the transfers of such items not being available.

Where a quoted price is not available, IFRS 13 states fair value shall be measured from the perspective of a market participant that holds the identical item as an asset. The logic is 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. Where a quoted price is not available and the identical item is not held by another party as an asset, IFRS 13 requires an entity to use a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity.

IFRS 13's hierarchical approach can be shown diagrammatically as follows:



Valuation techniques referred to in IFRS 13

IFRS 13 provides guidance on the use of valuation techniques when measuring fair value.

The Standard notes that there are three widely used ‘families’ of valuation techniques (see below) and states that entities should use valuation techniques consistent with one or more of them to measure fair value. IFRS 13’s valuation techniques apply to all methods of measuring fair value and include market-based approaches, and IFRS 13 does not prioritise the use of one valuation technique over another.

In some cases using only one of these valuation techniques will be appropriate. In other cases, multiple valuation techniques will be appropriate (eg when measuring a cash-generating unit the information available may enable the valuer to estimate a value based on both the income approach and market approach). In using valuation techniques, IFRS 13 emphasises that an entity should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. Specific guidance is then given on certain problematic areas including:

- the application of premiums and discounts, and
- bid and ask prices.

| Approach | Technique |
|----------------------------|---|
| The market approach | Uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business. |
| 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). |
| The income approach | Converts future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. The fair value measurement reflects current market expectations about those future amounts (eg present value techniques, option pricing models and the multi-period excess earnings method). |

The valuation techniques are commonly used as follows:

| Name | Market approach | Income approach | Cost approach |
|--|---|-----------------------------|--|
| Goodwill impairment | Often used for Fair Value less cost to sell | Often used for value in use | No |
| Shares/investments | Yes | Yes | No |
| Property | Yes | Yes | Certain specialised buildings |
| Tangible assets | Yes | Yes | Certain specialised machinery |
| Intangible assets | Depending on asset and data availability | Yes | For work force and some non-core intangible assets |
| Other financial assets and liabilities* | Yes | Yes | No |

*Certain financial assets and liabilities have specific treatment under IFRS which may differ from this.



Practical insight – Bid and ask prices

A bid price is the highest price a potential buyer is willing to pay (for an asset), and an ask price the lowest price a potential seller will accept. The difference is the bid-ask spread. In some markets both bid and ask prices are quoted, such as dealer markets, where the asset is transacted through a dealer rather than directly with a counter-party. In this case, the bid-ask spread generates a return for the dealer (buy low, sell

high) as compensation for their role. The more difficult the asset is to sell, the wider the bid-ask spread, to compensate the dealer for their risk.

If these prices are used as inputs to measure fair value, which point in the spread is the right fair value? On the face of it, it would seem that bid prices should always be used for assets and ask prices for liabilities. However, IFRS 13 provides more flexible guidance as follows:

- the reporting entity should use the price within the bid-ask spread that is most representative of fair value
- the use of bid prices for asset positions and ask prices for liability positions is permitted, but is not required, and
- the use of mid-market pricing or other pricing conventions used by market participants is not precluded as a practical expedient for fair value measurements within a bid-ask spread.

The existence of a 'true' bid-ask spread seems difficult to reconcile with IFRS 13's indication that initial fair value often equals the transaction price. This is because, all else being equal, an entity would purchase an asset at the (higher) ask price and would be able to sell it at the (lower) bid price. One way of explaining this is to characterise the difference as a transaction cost (eg a dealer's margin).

The application of premiums and discounts

IFRS 13 requires an entity to select inputs in a fair value measurement that are consistent with the characteristics of the asset or liability that market participants would take account of. The Standard notes in some cases this will result in the application of an adjustment such as a premium or discount where this is necessary to reflect the characteristic of the asset or liability.

Where a quoted price in an active market exists for the asset or liability, then that price is used without adjustment. Most often, however, no such price exists and the fair value measurement should then incorporate premiums or discounts if market participants would take them into account in a transaction for the asset or liability. Examples would be the incorporation of a control premium when measuring the fair value of a controlling interest, or a discount for lack of marketability when comparing the shares of a private company to those of a comparable publicly listed company.

Another example would be when valuing a minority stake using the precedents transactions method, where a discount for lack of control can be applied. Typically, when using the transactions method, implied multiples are based on an acquisition of 50% or greater (ie the acquisition of control). Entities would need to adjust the transaction multiple for a discount for lack of control when valuing a minority stake on this basis. This is just one example; the primary methods would still typically be a comparable company analysis and discounted cash flows. The discount for lack of control would not apply to the comparable company analysis method because the price for publicly listed companies is based on the acquisition of a small number of shares (ie a minority interest purchase).



Practical insight – Calibration of premiums and discounts

Where a valuation technique is used, IFRS 13 requires the use of calibration to ensure that inputs are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability.

Calibration enables valuers to quantify unobservable inputs such as premiums and discounts by ensuring the concluded valuation is consistent with the ‘day one’ fair value.

For example, in the application of a market approach using comparable company multiples for the valuation of a controlling stake in a private business, it is typical to apply:

- a discount for lack of marketability to reflect the privately held shares compared to the listed comparables, and
- a control premium to reflect the controlling stake in the company compared to the minority basis of the listed shares.

Such discounts and premiums are unobservable inputs and require the use of judgement. However, calibration can help to determine what the appropriate overall premium or discount should be. The steps are as follows:

- 1 Determine the day 1 valuation benchmark using the valuation technique, eg the profit multiple implied by the price paid
- 2 Assess the comparable companies profit multiples to determine an appropriate market benchmark, and
- 3 Calculate the discount or premium of the subject company to the market benchmark.

This provides a benchmark for the premium or discount at ‘day one’ which can be considered in subsequent valuations.

Where a premium or discount is reflective of the size of an entity’s holding as opposed to a characteristic of the holding (such as the controlling interest characteristic above), then the premium or discount should not be included in the fair value measurement. An example would be a blockage factor, ie an adjustment that would alter the quoted price of an asset or a liability because the market’s normal daily trading volume is not sufficient to absorb the quantity held by the entity.

| Allowed | Not permitted |
|--|---|
| Adjustments that are: <ul style="list-style-type: none">• consistent with the unit of account• reflective of the characteristics of the asset or liability. | Blockage factors – premiums or discounts that relate to the size of an entity’s holdings. |

The unit of account

IFRS 13 states a premium or discount should not be included in a fair value measurement if it is inconsistent with the unit of account. The unit of account itself is not specified by IFRS 13. Rather the requirements for determining the unit of account result from the application of other IFRS.

For financial instruments governed by IFRS 9, for example, the unit of account, will usually be the individual financial instrument. In contrast, the unit of account may be a group of assets or assets and liabilities where another Standard applies, for example, where recoverable amount of a cash-generating unit is determined by reference to fair value less costs of disposal under IAS 36. Problems may however be encountered where a particular Standard is not clear on the unit of account (see examples on page 16).

| Situation | Unit of Account |
|---|--|
| 100 shares in a large, quoted company measured at fair value through other comprehensive income (without subsequent recycling to profit or loss) in accordance with IFRS 9 | Each share |
| A non-controlling interest of 10%, comprising 100 shares, in an acquired entity to be measured at fair value under IFRS 3 | Generally considered to be entire non-controlling interest (but no adjustment to Level 1 inputs permitted) |
| A 100% holding in an unquoted subsidiary, comprising 100 shares, to be measured at fair value in accordance with IFRS 9 and IAS 27 in the parent's separate financial statements | Generally considered to be entire controlling interest |

The fair value hierarchy

IFRS 13 sets out a fair value hierarchy under which the inputs to valuation techniques used to measure fair value are categorised into three levels. The three levels of the hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly
- Level 3 inputs are unobservable inputs for the asset or liability.

This is summarised below:



The following table sets out some illustrative examples of classifications under each level

| Examples | Likely hierarchy level |
|--|--|
| Quoted shares in a company traded on a major stock exchange (quoted equity securities) | Level 1 |
| Unquoted shares in an unquoted private company, for which valuation uses earnings multiple from similar listed competitors along with various unobservable inputs (private equity) | Level 3 |
| Bonds traded on a market with quoted prices but infrequent recent transactions, where the last transaction was two weeks prior to reporting date. Valuation uses quoted price adjusted for observable market trends in past 2 weeks | Level 2 |
| Investment property valued using observable prices per square metre for similar properties with adjustments for specific characteristics | Level 2 or Level 3 (depending on the adjustments) |

Other products:

| | |
|---|---------|
| Asset-backed securities | Level 3 |
| Corporate bonds | Level 2 |
| Exchange traded derivatives - futures, options | Level 1 |
| Funds - exchange traded | Level 1 |
| Funds - valued (eg daily, weekly, monthly) | Level 2 |
| OTC derivatives - swaps, forwards, options | Level 2 |
| US Treasury bills (short dated maturity) | Level 1 |

Level 1 inputs are considered to be the most reliable measure of fair value, and are therefore given the highest priority within the hierarchy. Except for a few limited circumstances (where special criteria apply), Level 1 inputs must be used without adjustment whenever they are available. The least priority is given to Level 3 inputs.



IFRIC decision – prices received from third parties

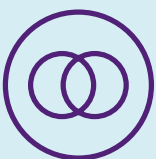
The IFRS Interpretations Committee (IFRIC) issued an agenda decision in January 2015 in relation to a request to clarify when prices provided by third parties would qualify as Level 1 in the fair value hierarchy. The IFRIC noted that when assets or liabilities are measured based on prices provided by third parties, the classification of those measurements within the fair value hierarchy will depend on the evaluation of the inputs used by the third party to derive those prices, instead of on the pricing methodology used. The fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. IFRS 13 states that only unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date qualify as Level 1 inputs. Therefore, a fair value measurement that is based on prices provided by third parties may only be categorised within Level 1 of the fair value hierarchy if the measurement relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date.

Where some of the inputs used in a fair value measurement fall within one level of the hierarchy and some within other levels, then the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.



Range of values

When valuation techniques present a range of fair values, the range should be considered reasonable. Valuation specialists are typically good at providing a reasonable range. Management should consider the point of the range which they consider to be most reflective of fair value using their knowledge and judgement, and if significant, this judgement should be disclosed in the financial statements.



Comparing valuers

Should two independent valuers, using the same data inputs always come up with the same amount?

If the valuation is a Level 1 hierarchy, then two independent valuers should come up with the same amount. However, if the valuation is based on Level 2 hierarchy, depending on the selected observable market inputs, there may be minor differences. For Level 3, the use of unobservable inputs rarely results in two independent valuers reaching the same conclusion. However, given the same data inputs they would expect to be broadly aligned.

Presentation and Disclosures in IFRS 13

IFRS 13 requires a comprehensive disclosure framework for fair value measurements. This framework is intended to help users of financial statements assess the valuation techniques and inputs used to develop those measurements.

As can be seen from the table below, the disclosures required are affected by the fair value hierarchy discussed above, with increased disclosure requirements applying to the lower levels of that hierarchy.

A distinction is also made between recurring fair value measurements (ie measurements made on a fair value basis at each reporting date) and non-recurring measurements (ie measurements triggered by particular circumstances). Disclosure of the effect of the fair value measurement on profit or loss or other comprehensive income for the period is required for recurring fair value measurements that involve significant unobservable (Level 3) inputs.

Disclosure requirements also apply to each class of asset and liability not measured at fair value in the statement of financial position but for which the fair value is disclosed.

| | Recurring | Non-recurring |
|--|------------------|-----------------|
| General disclosure requirements <ul style="list-style-type: none"> • fair value at the end of the period • reasons for the measurement. | ✓ | ✓ ✓ |
| General disclosures relating to the fair value hierarchy <ul style="list-style-type: none"> • the level of the fair value hierarchy in which the valuation falls* • the policy for determining when transfers between levels of the hierarchy are deemed to have occurred • reasons for transfers between different levels of the hierarchy • a description of the valuation techniques and inputs used in fair value measurements categorised within Levels 2 and 3 of the hierarchy*. | ✓ ✓ ✓ ✓ | ✓ ✓ ✓ |

* disclosure also required for assets and liabilities not measured at fair value but for which fair value is disclosed in the financial statements.

| | Recurring | Non-recurring |
|---|---|----------------------------|
| <p>Fair value hierarchy disclosures specific to Level 3 valuations</p> <ul style="list-style-type: none"> quantitative information about significant unobservable inputs used in fair value measurements* a reconciliation of changes in fair value movements, disclosing separately changes attributable to: <ul style="list-style-type: none"> total gains or losses recognised in profit or loss and the line item in which they are recognised total gains or losses recognised in other comprehensive income and the line item in which they are recognised purchases, sales, issues and settlements transfers into or out of Level 3 total gains or losses included in profit or loss attributable to the change in unrealised gains or losses for measurements within Level 3 a description of the valuation processes used for Level 3 measurements a narrative description of sensitivity analysis for Level 3 measurements the effect of altering an unobservable input where to do so would change the fair value significantly. | <p>✓</p> <p>✓</p> <p>✓</p> <p>✓</p> <p>✓</p> <p>✓</p> | <p>✓</p> <p>✓</p> <p>✓</p> |
| <p>Other disclosure requirements</p> <ul style="list-style-type: none"> for non-financial assets where highest and best use differs from current use, an explanation of why this is the case for liabilities measured at fair value and issued with an inseparable third-party credit enhancement, the existence of that credit enhancement and whether it is reflected in the fair value measurement of the liability where the exception of measuring a group of financial assets and financial liabilities on the basis of the net position is taken, disclosure of that fact. | <p>✓</p> <p>✓</p> <p>✓</p> | <p>✓</p> <p>✓</p> <p>✓</p> |

*disclosure also required for assets and liabilities not measured at fair value but for which fair value is disclosed in the financial statements.

“This framework is intended to help users of financial statements assess the valuation techniques and inputs used to develop those measurements.”



Practical insights – disclosures

A number of factors affect the amount and type of disclosures required, in particular:

Fair values on initial recognition

Fair values that are required or permitted only on initial recognition are exempted from IFRS 13's disclosures altogether. Examples of fair value on initial recognition include:

- using fair value as deemed cost on initial application of IFRSs in accordance with IFRS 1 'First-time Adoption of International Financial Reporting Standards'
- measuring most assets acquired and liabilities assumed in a business combination at fair value in accordance with IFRS 3
- initial recognition of financial assets and liabilities that will subsequently be measured at amortised cost in accordance with IFRS 9.

Level in the fair value hierarchy

As can be seen from the tables on pages 19 and 20, significant differences in disclosure requirements apply to the different levels within the fair value hierarchy. In particular, extensive disclosures are required for Level 3 measurements, in order to provide users with some insight into the reliability of such measurements.

These disclosures could be a challenge for some entities. For example, real estate valuations may end up being classified in Level 3 of the hierarchy where the valuation takes place in an inactive or less transparent real estate market, triggering the extensive disclosures referred to above. With the recent global COVID-19 pandemic still being present, certain industries will be impacted by risks and market conditions at the reporting date, and this should be considered when using the Level 3 valuation technique. For example, entities in the hospitality sector will be impacted by economic activity levels and suffer an increased forecasting risk. Therefore, they will be required to make significant disclosures around their Level 3 measurements.

Another example would be private capital markets (private equity and private debt).

For private debt, a direct lending fund would have issued a number of loans to various entities taking into account the financial health of each entity. The dynamics of the direct lending market and wider corporate bond market are very different. Therefore, it would be inappropriate to use observable inputs from the wider corporate bond market. In this case, the valuation of these direct lending loans would be classified as Level 3. It would require calculating the implied internal rate of return (IRR) at inception on the basis that the transaction was arm's length. The implied yield is then calibrated to the measurement date by observing to main drivers that would impact value; 1) credit quality, and 2) market rates.

Credit quality can be measured using synthetic credit ratings. Any changes would impact the yield and the change can be determined using the difference in spread of leveraged loan indices at two ratings. For example, rating at inception was A (A leveraged loan spread at 3%), rating at valuation date is now B (B leveraged loan spread at 4.5%). The deterioration in credit quality from A to B results in an increase to the implied yield of 1.5% (4.5%-3%).

Movements in market rates can also be observed in a similar manner by looking at wider leveraged loan index spreads.

Recurring versus non-recurring fair values

Some disclosures are required for recurring but not for non-recurring fair value measurements, and vice versa. An example of a recurring measurement is the fair value of derivatives and other held-for-trading financial items in IFRS 9. Examples of non-recurring fair value measurements include those required on classification of a non-current asset as held for sale in accordance with IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' and when making a non-cash distribution to owners under IFRIC 17 'Distributions of Non-cash Assets to Owners'.

Watch this space – A new disclosure approach coming

The IASB has recently issued an Exposure Draft 'Disclosure Requirements in IFRS Standards – A Pilot Approach'.

Investors say fair value measurement disclosures applying IFRS 13 generally contain information that meets their needs. However, these disclosures often contain detailed information about fair value measurements that are not material to the financial statements and are also costly to prepare. At the same time, investors say there can be limited information about the fair value measurements that are material to the reporting entity's financial statements.

The IASB proposes to replace the disclosure requirements in IFRS 13 with a new set of requirements developed that are designed to help reporting entities make more effective materiality judgements.

How we can help

We hope you find the information in this article helpful in giving you some insight into IFRS 13. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit www.grantthornton.global/locations to find your local member firm.

