Fair Value Measurement
Introduction
What is the objective of AASB 13?

AASB 13 (issued in 2011) sets out a framework for measuring fair value in a single standard, and answers:

#1: What is meant by “fair value”?

#2: How should an entity measure fair value?

#3: What should be disclosed about fair value measurements?
Scope of AASB 13
What is the scope of AASB 13?

Scope of AASB 13

Applies when another IFRS requires or permits fair value measurements or disclosures

Applies to both initial and subsequent measurement as to how to determine fair value

The scope of AASB 13 is broad.
The scope of AASB 13 is broad

- Business Combinations
- Financial Instruments
- Investment Property
- Non-current Assets Held for Sale Discontinued Operations
- Impairment of assets
- Biological assets
- Property, Plant and Equipment
- Intangible assets
- Revenue
Process and controls
Process and controls
Definition of fair value and key principles
Definition of fair value

**Asset**
The price that would be received to sell the asset

**Liability**
The price that would be paid to transfer the liability

**Fair value is an**
EXIT PRICE

In an **orderly transaction**

Between **market participants**

At **measurement date**

- NOT based on how much the reporting entity has to pay to settle a liability
- Should be based on how much the reporting entity has to pay to a market participant such that the market participant is willing to take over the liability
What should be considered in determining fair value?

**Unit of account**
- What is being measured?
- What is the appropriate *unit of account*? Is it the same as the basis for valuation?

**Market**
- What is the principal (or if none exists, the most advantageous) market?

**Assumptions**
- What *assumptions* would market participants in the principal (or the most advantageous) market take into account when pricing the asset or liability?
- What *characteristics* of the asset or liability would market participants take into account?

**Inputs and valuation techniques**
- What *inputs* are available and could be used in determining the fair value? What is (are) the appropriate *valuation technique(s)*?
**The market**

**Most advantageous market**
(the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs)

**Principal market**
(the market with the greatest volume or level activity for the asset or liability)

In the absence of the principal market

A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in...
The Price: Characteristics of the asset or liability

- Market participants
  - Pricing assumptions
  - Characteristics of asset or liability

Assume they act in their best economic interest

- Fair value of asset or liability
  - Condition and location
  - Restrictions on sale or use
Initial measurement
Fair value vs. transaction price

In many cases, the transaction price will equal the fair value (e.g., on the transaction date, the transaction to buy an asset takes place in the market in which the asset would be sold).

AASB 13 requires us to take into account factors that are specific to the transaction and to the asset or liability.

Transaction price might not equal fair value if...

- Transaction is between related parties (i.e., transactions may include capital contribution / distribution element)
- Transaction takes place under duress or the seller is forced to accept the price in the transaction
- Unit of account represented by the transaction price differs from the unit of account for the asset or liability measured at fair value (e.g., a business combination situation)
- The market in which the transaction takes place is different from the principal (or most advantageous) market

AASB 13 requires us to take into account factors that are specific to the transaction and to the asset or liability.
Application of fair value measurement to non-financial assets
A fair value measurement of a non-financial asset should take 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.

**Highest and best use:**
the use by market participants that would maximise the value of the asset or the group of assets and liabilities within which the asset would be used.

- **Physically possible?** (location or size of the asset)
- **Legally permissible?** (legal restrictions on the use of the asset)
- **Financially feasible?** (ability to generate adequate income or cash flows to produce an investment return that market participants expect)
Non-financial assets

Highest and best use

Determined from market participant’s perspective (even if reporting entity intends a different use)

Entity’s current use presumed to be highest and best use (unless market or other factors suggest a different use by market participants would maximise the value)

Highest and best use must be supportable

Note: Applies only to non-financial assets
Valuation premise for non-financial assets

The highest and best use of a non-financial asset

Provide maximum value to market participants on a **stand-alone** basis

Provide maximum value to market participants through its use in combination with other assets and liabilities **as a group**

**Fair value:**
the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a **stand-alone basis**

**Fair value:**
the price that would be received in a current transaction to sell the asset assuming it would be used with other assets and liabilities which would be available to market participants
Applying the valuation premise: Example

Step 1 – Determine the highest and best use of the R&D (Maximum value to market participants)

Option 1: Continue development if market participants would continue to do so

Option 2: Cease development if, for competitive reasons, market participants would lock up the project

Option 3: Cease development if market participants would discontinue its development

Assume Option 1 represents the highest and best use for market participants

Step 2 – Determine fair value of the R&D
Determined on the premise of how much a market participant would pay the reporting entity for the R&D and that the market participant would continue development of the R&D.
Valuation techniques
Valuation techniques

- No rules as to which valuation technique(s) must be used
- Select the most appropriate technique in the circumstances, for which sufficient data is available
- Apply consistently
- Change in technique = change in accounting estimate (AASB 8)

Inputs

- Maximise use of relevant observable inputs
- Minimise use of unobservable inputs
- Select inputs that are consistent with characteristics of asset or liability (from market participant perspective)
- Consider:
  - Location and condition
  - Restrictions on sale or use
Valuation techniques

- Market approach
  - Prices and other relevant information generated by market transactions involving identical or comparable items

- Cost approach
  - Current replacement cost

- Income approach
  - Convert the future amounts into a single current amount
Valuation techniques include:
- Present value techniques;
- Option pricing models (e.g., the Black-Scholes-Merton formula or a binomial model);
- The multi-period excess earnings method (normally used to measure the fair value of some intangible assets).
Present value techniques

Capture all of the following elements:

• An estimate of future cash flows for the asset or liability being measured
• Expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows
• The time value of money (i.e., a risk-free interest rate)
• The price for bearing the uncertainty inherent in the cash flows (i.e., a risk premium)
• Other factors that market participants would take into account in the circumstances
• For a liability, the non-performance risk relating to that liability, including the entity’s own credit risk
Present value techniques

General principles:

• Cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability.

• Cash flows and discount rates should take into account only the factors attributable to the concerned asset or liability.

• To avoid double-counting or omitting the effects of risk factors.

• Assumptions about cash flows and discount rates should be internally consistent.

• Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

For example, if contractual cash flows of a loan are used, the discount rate should reflect the uncertainty in expectations about future defaults.

However, if expected cash flows are used, that discount rate should not be used.
Factors to consider

- The appropriateness (i.e., relevance and applicability of each valuation technique)
- Whether there is sufficient reliable data available to support a particular approach
- Comparative level of the alternative approaches in the fair value hierarchy
- Any significant decline in volume and level of market activity
- View of market participants on the relevance of valuation techniques

Judgement is required taking into account the relevant fact and circumstances
Fair value hierarchy
Fair value hierarchy

- The fair value hierarchy is applicable to both financial and non-financial items that are within the scope of AASB 13.
- The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets and liabilities and the lowest priority to unobservable inputs.
- The fair value measurement is categorised in its entirety based on the lowest level of significant input.
- Fair value hierarchy depends on the inputs, not valuation techniques.
Fair value hierarchy

Any quoted price for an identical asset or liability (Level 1 inputs)?

- Yes: Use the Level 1 input = Level 1 measurement (must be unadjusted)
- No: Any observable inputs other than Level 1 inputs?
  - Yes: Use of observable inputs that are significant to the measurement in its entirety = Level 2 measurement
  - No: Use of unobservable inputs that are significant to the measurement in its entirety = Level 3 measurement
Fair value hierarchy—Level 2

Level 1
Quoted prices in active market for identical assets or liabilities

Level 2
Observable inputs other than quoted prices in level 1, either directly or indirectly

Level 3
Unobservable inputs

• If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability

• Level 2 inputs include the following:
  • Quoted prices for similar assets or liabilities in active markets
  • Inputs other than quoted prices that are observable for the asset or liability (e.g., observable interest rates and yield curves).
Fair value hierarchy—Level 3

Level 1
Quoted prices in active market for identical assets or liabilities

Level 2
Observable inputs other than quoted prices in level 1, either directly or indirectly

Level 3
Unobservable inputs

• The fair value measurement objective remains the same—exit price
• Entities should try to select the most reliable among unobservable inputs
• The Level 3 measurement inputs should include risk inherent in the particular valuation technique and the risk inherent in the inputs to the valuation technique
• Examples of Level 3 inputs
  • Labour quotes for a particular job in determining the fair value of a decommissioning liability in a business combination
  • Profit/cash flow forecast used in determining the fair value of a cash-generating unit (e.g., cash flows or profit or loss forecast).
Who undertakes the valuation?
Who undertakes the valuation

**Management**
- Do they have the relevant skills & expertise to prepare the calculation?

**External party**
- How selected (are they independent?)
- What are their relevant skills, qualifications and expertise
- What instructions were issued
Commissioning an external valuer

- Independence
- Expertise and qualifications
- Expert’s involvement / knowledge or recent market transactions
- Cost and time considerations
- Rotation
Disclosures
Disclosures

Recurring basis

Recurring fair value measurements of assets or liabilities are those that other AASBs require or permit in the statement of financial position at the end of each reporting period.

Examples

- Investment properties measured using the fair value model under AASB 140
- Financial assets at fair value through profit or loss (e.g., held-for-trading investments) under AASB 139/AASB 9
- Available-for-sale investments under AASB 139
- Property, plant and equipment/intangible assets measured using the revaluation model under AASB 116 / AASB 138
- Biological assets under AASB 141

Disclosures under applicable standards

For example AASB 116 – for revalued PPE the effective date of the revaluation, whether an independent valuer was involved etc

For impairment – various disclosures under AASB 136

For intangibles – AASB 138
What to look for
What to look for…

The role of directors & audit committees

- Each director has a duty of skill, competence and diligence in understanding the company’s financial report.

- You should determine that the information in the financial report is consistent with your knowledge of the entities financial position and affairs.

- The existence of an audit committee does not alter the need for directors to take responsibility for financial reports.

- Although calculations supporting valuations (or impairment) of significant assets can be complex, you can review the cash flows and assumptions used in calculations prepared by management or experts for material assets bearing in mind your knowledge of the business, the assets, the environment in which the company operates and the future prospects of the business.

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Challenging the expert

*Fair Value Measurement*

**What to look for**

- What were the instructions given to independent valuers?
- Is the valuation AASB compliant?
- Methodology selected and the basis for that selection
- What are the key assumptions in the valuations?
- How are the assumptions developed?
- Are they reasonable assumptions?
- What is the impact of changes in key assumptions and why did they change?
- How sensitive is the valuation to changes in key assumptions?
- Areas where the expert has applied significant judgment
- How to assess the reasonableness of valuations?
Questions for the auditor
Questions for the auditor

- Is there an appropriate valuation framework and are there appropriate processes and controls in place?
- How have models been developed / have they been checked for integrity?
- Is there adequate review of the valuations by persons independent of those undertaking the work?
- Was the valuation appropriately documented by management and provided on a timely basis?
- Have any concerns the auditor has raised previously been addressed?
- Does the auditor have the appropriate experience and expertise to review the fair values?
- Did the auditor engage any experts to review the work prepared by management or management's experts?
- Did the auditor demonstrate sufficient professional scepticism in challenging, rather than rationalising, cash flows and assumptions?
- Does the auditor have any concerns about the value of non-current assets?