

This Agenda paper discusses:

- (a) the relevance of the principles and requirements in the IASB's forthcoming *Fair Value Measurement* Standard to a superannuation plan or approved deposit fund; and**
- (b) what guidance, if any, the replacement Standard for AAS 25 might need to facilitate the reliable and consistent application of the principles and requirements in the IASB's forthcoming *Fair Value Measurement* Standard**

Background

1. ED 179 *Superannuation Plans and Approved Deposit Funds* proposes that a superannuation plan or approved deposit fund (ADF) measure all of its assets and liabilities at their fair values except for:
 - (a) tax assets and tax liabilities;
 - (b) liabilities and assets arising from insurance contracts issued by the plan or ADF;
 - (c) obligations for defined contribution members' vested benefit and defined benefit members' accrued benefits; and
 - (d) goodwill acquired in a business combination.

At its December 2009 meeting, the Board affirmed that the replacement Standard for AAS 25 *Financial Reporting by Superannuation Plans* should require a plan or ADF to measure all assets and liabilities except for those described in (a) – (d) above at their fair values at the end of each reporting period.

2. To facilitate the disclosure of information that provides users with a basis for understanding how the fair values of assets and liabilities are determined, ED 179 proposes that a plan or ADF disclose information in accordance with the requirements in paragraphs 27-27B of AASB 7 *Financial Instruments: Disclosures*.
3. In their responses to the proposals in ED 179, a number of constituents recommended that, where applicable, the replacement Standard for AAS 25 should place greater emphasis on referring to the disclosure principles and requirements in other Australian Accounting Standards rather than replicate or paraphrase those disclosure principles and requirements. The respondents suggested that such an approach is preferable to the approach in ED 179 because:
 - (a) preparers and auditors will generally still need to consider the relevant requirements in other Standards; and
 - (b) over time, the principles and requirements in other Standards will change, which would otherwise necessitate amendments to the replacement Standard for AAS 25.
4. At its February 2010 meeting, the Board tentatively decided that the replacement Standard for AAS 25 should, where necessary and applicable, refer to the disclosure principles and requirements in other relevant Australian Accounting Standards rather than replicate or paraphrase those disclosure principles and requirements. In addition, the Board decided that staff should prepare an issues paper for consideration at a future meeting that considers:
 - (a) the relevance of the proposed principles and requirements in the IASB's forthcoming *Fair Value Measurement* Standard to a plan or ADF; and
 - (b) what guidance, if any, the replacement Standard might need to include to facilitate the reliable and consistent application of the IASB's proposed fair value disclosure principles and requirements.
5. Accordingly, the purpose of this Agenda paper is to:

- (a) consider the potential relevance of the proposals in the IASB's ED/2009/5 *Fair Value Measurement* and the decisions made to date by the IASB in relation to the proposals in ED/2009/5 (paragraphs 6-9); and
- (b) consider whether the replacement Standard for AAS 25 should include superannuation-specific guidance to facilitate the reliable and consistent application of the IASB's forthcoming *Fair Value Measurement* Standard (paragraph 10).

The relevance of the proposals in ED/2009/5 to a plan or ADF

- 6. Appendix A to this Agenda paper provides the main proposals in ED 179 dealing with the disclosure of information in relation to assets and liabilities measured at fair value under the replacement Standard for AAS 25. In addition, Appendix A provides selected paragraphs from the Basis for Conclusions to ED 179 which explain the Board's conclusions in relation to these proposals.
- 7. The proposed fair value disclosure principles and requirements in ED 179 are based upon the requirements in paragraphs 27-27B of AASB 7. It is relevant to note, however, that ED/2009/5 proposes that the material in paragraphs 27-27B and 28 of IFRS 7 *Financial Instruments: Disclosures* be incorporated into the IASB's forthcoming *Fair Value Measurement* Standard. Appendix B to this Agenda paper provides the main proposals in ED/2009/5, including Appendix B (application guidance) and Appendix C (guidance in relation to present value techniques).
- 8. Table A below provides a summary of staff views on the relevance of the various proposals in ED/2009/5 to a plan or ADF.

Table A – Staff views on the relevance of the proposals in the IASB’s ED/2009/5 *Fair Value Measurement* to a plan or ADF

Paragraph number	Fair value measurement proposal	Staff view	Staff comments
1	Core principle	Relevant	ED 179 proposes that, in determining the fair value of an asset or liability, a plan or ADF consider the relevant Australian Accounting Standards. Accordingly, the concept of fair value under the replacement Standard for AAS 25 would be consistent with the concept of fair value proposed in ED/2009/5. In addition, it is relevant to note that AAS 25 requires an entity to measure its assets and liabilities at net market value, which is defined as the amount which could be expected to be received from the disposal of an asset in an orderly market. Accordingly, staff consider that fair value as proposed in the ED/2009/5 and market value as applied under AAS 25 are conceptually similar.
2-3	Scope of the forthcoming IFRS	Relevant	The forthcoming <i>Fair Value Measurement</i> Standard would apply to IFRSs that require or permit fair value measurements. ED 179 proposes that, in determining the fair value of an asset or liability, a plan or ADF consider the relevant Australian Accounting Standard or Standards.
4-6	Fair value measurement of a particular asset or liability	Relevant	No specific comments.
7-12	Transaction is assumed to occur in the most advantageous market to which the entity has access	Relevant	The vast majority, if not all, of the different types of assets and liabilities held by a plan or ADF would also be held by entities outside of the superannuation industry. It is relevant to note that some plans and ADFs hold investments in collective arrangements that have only other plans and ADFs as investors (for instance, Members’ Equity Bank). Nevertheless, the proposals in paragraphs 7-12 are consistent with the expectation that a plan’s interest in such a collective arrangement would be sold to one or more of the other investors in the arrangement. In addition, at a conceptual level, these types of collective investment arrangements arguably pose no additional measurement issues than investments in, for instance, wholesale managed trusts or private equity investments.
13-14	Fair value is determined using assumptions that market participants would use	Relevant	Paragraph 13(c) notes that market participants are buyers and sellers in the most advantageous market for the asset or liability that are able to enter into a transaction for the asset or liability. As noted above, some plans and ADFs hold assets in collective arrangements that involve only other plans and/or ADFs. Nevertheless, the proposals in paragraphs 13-14 are consistent with the expectation that the fair value of an interest in such a collective arrangement would be determined using the assumptions that other participants in such collective arrangements would make in respect of valuing the collective investment.

Table A - Staff views on the relevance of the proposals in the IASB's ED/2009/5 *Fair Value Measurement to a plan or ADF* (continued)

Paragraph number	Fair value measurement proposal	Staff view	Comments
15-16	Fair value is the price received to sell an asset/transfer a liability and excludes transaction costs	Relevant	As noted above, ED 179 proposes that, in determining the fair value of an asset or liability, a plan or ADF consider the relevant Australian Accounting Standards. Accordingly, the concept of fair value under the replacement Standard for AAS 25 would be consistent with the concept of fair value proposed in ED/2009/5.
17-21	Fair value of an asset considers market participants' highest and best use	Relevant	Paragraph 18 clarifies that the highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. This may compel some trustees to reconsider how much of the fair value of a non-financial asset is credited to member's accounts, particularly where the 'in-use' valuation differs from the 'in-exchange' valuation. However, it is relevant to note that: (a) the SIS Act 'sole purpose' test prohibits a plan or ADF from operating a business. Accordingly, very few plans and ADFs have material exposures to non-financial assets; and (b) similar issues would potentially arise in the context of other investment-type entities that currently apply IFRSs, such as managed investment schemes.
22-24	Highest and best use establishes the valuation premise used to measure fair value	Relevant	See comments in relation to paragraphs 17-21 above. In addition, paragraph 24 proposes that an entity use an in-exchange valuation premise when measuring the fair value of a financial asset. Most assets held by a plan or ADF are financial in nature.
25-28	General principles for fair value measurement of liabilities	Relevant	Although plans and ADFs are prohibited from borrowing or otherwise leveraging their assets, some plans have subsidiaries with borrowings.
29-30	Fair value of a liability reflects the effect of non-performance risk	Relevant	See comments in relation to paragraphs 25-28 above.

Table A - Staffs' views on the relevance of the proposals in the IASB's ED/2009/5 *Fair Value Measurement to a plan or ADF* (continued)

Paragraph number	Fair value measurement proposal	Staffs' view	Comments
31	Restrictions over transferring liabilities	Relevant	Although plans and ADFs are prohibited from borrowing or otherwise leveraging their assets, some plans have subsidiaries with borrowings.
32-33	Fair value measurement of an equity instrument	Relevant	Regulated plans and ADFs are not permitted to issue equity instruments because they are required to be operated for the sole benefit of members and beneficiaries. However, some plans recognise non-controlling interests as a consequence of holding a controlling interest in a subsidiary. At its February 2009 meeting, the Board decided that a plan or ADF should measure any non-controlling interests in a subsidiary in accordance with paragraph 19 of AASB 3 <i>Business Combinations</i> (at fair value or non-controlling interests' proportionate share of the acquiree's identifiable net assets) at the subsidiary's acquisition date and in accordance with paragraph 18 of AASB 127 <i>Consolidated and Separate Financial Statements</i> (amount of non-controlling interests at acquisition date plus non-controlling interests' share of changes in equity since acquisition) at the end of each subsequent reporting period.
34-37	Fair value measurement at initial recognition	Relevant	No specific comments.
38-40	Valuation techniques	Relevant	No specific comments.
41-42	Inputs to valuation techniques	Relevant	No specific comments.
43-55	Fair value hierarchy, including Levels 1, 2 and 3 inputs and inputs based on bid and ask prices	Relevant	No specific comments.
56-61	Disclosures	Relevant	It is relevant to note that some of the material in paragraph 57 was included in Appendix B to ED 179 (see Appendix A to this Agenda paper).
Appendix B	Application guidance	Relevant	The material contained in Appendix B is consistent with the proposals in the body of ED/2009/5.
Appendix C	Present value techniques	Relevant	The material contained in Appendix C is consistent with the proposals in the body of ED/2009/5.

9. It is relevant to note that the IASB has been redeliberating the proposals in ED/2009/5 since its January 2010 meeting. Staff have reviewed the IASB's decisions to date in relation to the proposals in ED/2009/5 and consider that all of those decisions in relation to the proposals in the ED would be relevant to a plan or ADF under the replacement Standard for AAS 25.

Should the replacement Standard for AAS 25 include superannuation-specific guidance to facilitate the reliable and consistent application of the IASB's forthcoming *Fair Value Measurement* Standard?

10. As noted in Table A above, staff consider that some plans and ADFs may experience practical difficulties in applying the proposals in ED/2009/5 to some of their assets and liabilities, including non-financial assets and investments in collective arrangements that are exclusively held by superannuation entities. Nevertheless, staff do not consider that these practical difficulties are sufficient to warrant the inclusion of superannuation-specific application guidance in the replacement Standard because:
- (a) very few plans and ADFs have material exposures to non-financial assets;
 - (b) collective investment arrangements in the superannuation industry arguably pose no additional measurement issues to other types of collective investments held by entities both within and outside of the superannuation industry. For instance, wholesale managed trusts and private equity investments; and
 - (c) these practical issues would not be unique to superannuation entities and would potentially arise in the context of other investment-type entities that currently apply IFRSs, such as managed investment schemes.

Staff views

Staff consider that:

- (a) the proposals in the IASB's ED/2009/5 *Fair Value Measurement* and the decisions made to date by the IASB in relation to the proposals in ED/2009/5 would be relevant to a plan or ADF under the replacement Standard for AAS 25; and
- (b) consistent with the discussion in Agenda paper 6.2 to the Board's February 2010 meeting and Agenda paper 14.4 to this meeting, staff consider that the inclusion of application guidance in the replacement Standard for AAS 25 would run the risk of introducing interpretations into Australian Accounting Standards that may not be consistent with the ways in which the principles and requirements in the IASB's forthcoming *Fair Value Measurement* Standard are interpreted in other contexts.

APPENDIX A - Selected paragraphs from ED 179 *Superannuation Plans and Approved Deposit Funds*

Disclosures

Nature of the Entity, Nature of Member Benefits, Expense Items and Fair Value Measurement

32 A superannuation plan or approved deposit fund shall disclose information that provides users with a basis for understanding:

- (a) the nature of the entity and the nature of the benefits it provides to its members;**
- (b) the nature and amount of expenses incurred by the entity; and**
- (c) how the fair values of assets and liabilities of the entity are determined.**

33 To meet the objectives in paragraph 32, an entity discloses, as a minimum, the information specified in paragraphs AG52, AG53-AG56 and AG57-AG60 of Appendix B to this Standard.

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Fair Value

AG57 To comply with paragraph 32(c) of this Standard, a superannuation plan or approved deposit fund discloses, for each class of asset and liability measured at fair value, the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of asset and liability measured at fair value. For example, if applicable, a plan or fund discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. If there has been a change in valuation technique, the plan or fund would disclose that change and the reasons for making it.

AG58 To make the disclosures required by paragraph AG59, a superannuation plan or approved deposit fund would classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy would have the following levels:

- (a) quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);
- (b) inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (for example, as prices) or indirectly (for example, derived from prices) (Level 2); and
- (c) inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

The level in the fair value hierarchy within which the fair value measurement is categorised is determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. For this purpose, the significance of an input is assessed against the fair value measurement in its entirety. If a fair value measurement uses observable inputs that require significant adjustment based on unobservable inputs, that measurement is a Level 3 measurement. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgement, considering factors specific to the asset or liability.

AG59 For fair value measurements recognised in the statement of financial position, a superannuation plan or approved deposit fund discloses for each class of asset or liability measured at fair value:

- (a) the level in the fair value hierarchy into which the fair value measurements are categorised in their entirety, segregating fair value measurements in accordance with the levels identified in paragraph AG58;
- (b) any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level shall be disclosed and discussed separately from transfers out of each level. For this purpose, significance would be judged with respect to profit or loss, and total assets or total liabilities;
- (c) for fair value measurements in Level 3 of the fair value hierarchy, a reconciliation from the beginning balances to the ending balances, disclosing separately changes during the period attributable to the following:

- (i) total gains or losses for the period recognised in the income statement, and a description of where they are presented in the income statement (if presented);
 - (ii) purchases, sales, issues and settlements (each type of movement disclosed separately); and
 - (iii) transfers into or out of Level 3 (for example, transfers attributable to changes in the observability of market data) and the reasons for those transfers. For significant transfers, transfers into Level 3 would be disclosed and discussed separately from transfers out of Level 3;
- (d) the amount of total gains or losses for the period in (c)(i) above recognised in the income statement that are attributable to gains or losses relating to those assets and liabilities held at the end of the reporting period and a description of where those gains or losses are presented in the income statement (if presented); and
- (e) for fair value measurements in Level 3, if changing one or more of those inputs to reasonably possible alternative assumptions would change fair value significantly, the plan or fund would state that fact and disclose the effect of those changes. The plan or fund would disclose how the effect of the change to a reasonably possible alternative assumption was calculated. For this purpose, significance would be judged with respect to profit or loss, and total assets or total liabilities.

A plan or fund would present the quantitative disclosures required by this paragraph in tabular format unless another format is more appropriate.

AG60 Consistent with paragraph 125 of AASB 101, a superannuation plan or approved deposit fund would disclose information in relation to any major sources of estimation uncertainty that have a significant risk of resulting in material adjustments to the fair values of its assets or liabilities measured at fair value adjusted for transaction costs.

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BASIS FOR CONCLUSIONS

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Measurement of assets

- BC20 AAS 25 requires a superannuation plan to measure its assets at market value less costs that would be expected to be incurred in realising the proceeds from their disposal. The AASB considered a number of alternative approaches, including measuring assets:
- (a) in a manner consistent with the approach under AAS 25;
 - (b) in accordance with the various requirements of relevant Australian Accounting Standards; and
 - (c) in a manner consistent with the 'fair value approach' as described in AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*.
- BC21 With respect to approaches (b) and (c), the AASB noted that some Australian Accounting Standards currently provide a choice between alternative measurement methods, particularly cost and fair value, for particular types of assets. However, the measurement of superannuation assets at cost is inconsistent with the interest of users in the investment performance of superannuation plans and approved deposit funds, and inconsistent with the prudential measurement requirements.
- BC22 The AASB concluded that the approach under AAS 25 is an appropriate starting point for developing measurement principles for the assets of a superannuation plan or approved deposit fund. However, the AASB noted that there are a number of compelling arguments in favour of requiring a superannuation plan or approved deposit fund to use fair value rather than market value.
- BC23 Both market value measurements and fair value measurements provide useful information for users of the financial statements of a superannuation plan or approved deposit fund about:
- (d) the capacity of a superannuation plan, with defined contribution members, or an approved deposit fund to pay benefits as it reflects the interests of members; and

- (e) the financial position (solvency) of a superannuation plan with defined benefit members as it reflects the capacity of the entity to meet member benefits.

However, the approach for measuring assets under AAS 25 is inconsistent with the approach for measuring equivalent assets under other Australian Accounting Standards. Under AAS 25, all assets are required to be measured at their 'asking' prices at the end of the each reporting period. In contrast, under other Australian Accounting Standards, assets measured at fair value are generally measured at their 'bid' prices. In addition, fair value measurement is more comprehensively dealt with in the accounting literature, which includes the relevant guidance in Australian Accounting Standards, than the way in which market value measurement is dealt with in AAS 25. For example, AASB 139 *Financial Instruments: Recognition and Measurement* provides detailed guidance on when a 'bid price' or an 'asking price' would be used to measure a financial liability. In contrast, AAS 25 provides no equivalent guidance with respect to the measurement of financial liabilities. Accordingly, the AASB considers that requiring superannuation plans and approved deposit funds to measure their assets at fair value would enhance the comparability of the financial statements of superannuation plans and approved deposit funds with other entities.

- BC24 In the interests of providing useful information to users, and noting that fair value measurement is required for plan assets attributable to defined benefit members under AASB 119, the AASB concluded that ED 179 should propose that a superannuation plan or approved deposit fund measure all of its assets except for tax assets, assets arising from insurance contracts and goodwill at fair value, and that a plan or fund apply the concept of fair value as defined in Australian Accounting Standards.

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Measurement of liabilities other than tax liabilities, member benefits and obligations arising from insurance contracts

- BC32 AAS 25 requires a superannuation plan to measure its financial liabilities at net market value.
- BC33 The AASB considered the different ways in which a liability can be measured under Australian Accounting Standards, in particular:
- (f) at fair value; and
 - (g) at amortised cost.
- BC34 The AASB concluded that amortised cost is not an appropriate method of measuring liabilities in a superannuation context because it does not result in useful information to users. For example, measuring borrowings in a subsidiary at amortised cost is unlikely to provide users with information that is relevant for an understanding of the financial position of a parent superannuation plan or parent approved deposit fund and its subsidiaries. In addition, the AASB noted that measuring assets attributable to defined contribution members at cost can undermine trustees' efforts to treat members equitably, particularly during periods of rapid asset price inflation or deflation. Accordingly, the AASB concluded that a superannuation plan or approved deposit fund should measure all of its liabilities other than tax liabilities, member benefits and obligations arising from insurance contracts at fair value. In addition, consistent with its conclusions in relation to the treatment of transaction costs in respect of assets, the AASB concluded that a plan or fund should treat transaction costs attributable to a liability measured at fair value as an increase in the carrying amount of the liability.

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APPENDIX B - Selected paragraphs from the IASB's ED/2009/5 *Fair Value Measurement*

Core principle

- 1 ***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.***

Scope

- 2 This [draft] IFRS applies to IFRSs that require or permit fair value measurements or disclosures, except that it does not replace the requirement in paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement*.
- 3 This [draft] IFRS explains how to measure fair value. It does not require additional fair value measurements.

Measurement

Fair value

- 4 The following paragraphs discuss aspects of the core principle:
- (a) the asset or liability (paragraphs 5 and 6)
 - (b) the transaction (paragraphs 7–12)
 - (c) market participants (paragraphs 13 and 14)
 - (d) the price (paragraphs 15 and 16)
 - (e) application to assets (paragraphs 17–24)
 - (f) application to liabilities (paragraphs 25–31)
 - (g) application to equity instruments (paragraphs 32 and 33).

The asset or liability

- 5 **A fair value measurement is for a particular asset or liability. Therefore, the measurement shall consider the characteristics of the asset or liability (eg the condition and location of the asset and restrictions, if any, on its sale or use) if market participants would consider those characteristics when determining the price for the asset or liability at the measurement date.**
- 6 The asset or liability might be a stand-alone asset or liability (eg a financial instrument or an operating asset) or a group of assets or liabilities (eg a cash-generating unit or a business) depending on the *unit of account* prescribed by IFRSs applicable to the asset or liability or group of assets or liabilities.

The transaction

- 7 A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is 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 (eg a forced liquidation or distress sale).
- 8 **A fair value measurement shall assume that the transaction to sell the asset or transfer the liability takes place in the *most advantageous market* to which the entity has access. The most advantageous market is 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 considering *transaction costs and transport costs*.**

- 9 Because different entities (and businesses within those entities) with different activities enter into transactions in different markets, the most advantageous market for the same asset or liability might be different for different entities. Therefore, the most advantageous market (and thus, market participants) shall be considered from the perspective of the reporting entity.
- 10 An entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market. The market in which the entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market.
- 11 In the absence of evidence to the contrary, an entity may assume that the *principal market* for the asset or liability is the most advantageous market, provided that the entity can access the principal market.* The principal market is the market with the greatest volume and level of activity for the asset or liability. Regardless of the market used, an entity shall apply the fair value hierarchy as described in paragraphs 43 and 44.
- 12 In the absence of an actual transaction to sell the asset or transfer the liability at the measurement date, a fair value measurement assumes a hypothetical transaction at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That hypothetical transaction notion establishes a basis for estimating the price to sell the asset or to transfer the liability. Because the transaction is hypothetical, it is necessary to consider the characteristics of market participants who would enter into a transaction for the asset or liability.

Market participants

- 13 Market participants are buyers and sellers in the most advantageous market for the asset or liability that are:
- (a) independent of each other, ie they are not related parties (as defined in IAS 24 *Related Party Disclosures*);
 - (b) knowledgeable, ie they are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability;
 - (c) able to enter into a transaction for the asset or liability; and
 - (d) willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.
- 14 **The fair value of the asset or liability shall be measured using the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, an entity need not identify specific market participants. Rather, the entity shall identify characteristics that distinguish market participants generally, considering factors specific to:**
- (a) **the asset or liability,**
 - (b) **the most advantageous market for the asset or liability and**
 - (c) **market participants with whom the reporting entity would enter into a transaction in that market.**

The price

- 15 Fair value is the price that would be received to sell an asset or paid to transfer a liability in the most advantageous market at the measurement date (an exit price), whether that price is directly observable or estimated using a valuation technique. In the absence of an observable market to provide pricing information, an entity shall consider the characteristics of market participants who would enter into a transaction for the asset or liability.
- 16 Although transaction costs are considered when determining the most advantageous market, the price used to measure the fair value of the asset or liability shall not be adjusted for those costs.* Transaction costs are the incremental direct costs to sell the asset or transfer the liability. Transaction costs are not a characteristic of the asset or liability; rather, they are specific to the transaction and will differ depending on how an entity enters into a transaction for an asset or liability. Transaction costs do not include the costs that would be incurred to transport an asset to or from its most advantageous market.

If location is a characteristic of the asset (as might be the case for a commodity), the price in the most advantageous market shall be adjusted for the costs, if any, that would be incurred to transport the asset to or from that market.

Application to assets: highest and best use

- 17 A fair value measurement considers a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its *highest and best use*. Highest and best use refers to the use of an asset by market participants that would maximise the value of the asset or the group of assets and liabilities (eg a business) within which the asset would be used, considering uses of the asset that are physically possible, legally permissible and financially feasible at the measurement date. A use that is:
- (a) physically possible takes into account the physical characteristics of the asset that market participants would consider when pricing the asset (eg the location or size of a property).
 - (b) legally permissible takes into account any legal restrictions on the use of the asset that market participants would consider when pricing the asset (eg the zoning regulations applicable to a property).
 - (c) financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into consideration the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.
- 18 Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, an entity need not perform an exhaustive search for other potential uses if there is no evidence to suggest that the current use of an asset is not its highest and best use.
- 19 The highest and best use of an asset acquired in a business combination might differ from the intended use of the asset by the acquirer. For competitive or other reasons, the acquirer may intend not to use an acquired asset actively or it may not intend to use the asset in the same way as other market participants. This might be the case for some acquired intangible assets, eg an acquired trademark that competes with an entity's own trademark. Nevertheless, an entity shall measure the fair value of the asset assuming its highest and best use by market participants.
- 20 In some cases, an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset. For example, an entity might operate a factory on a parcel of land even though the highest and best use of the land is to demolish the factory and build residential property. In such cases, the fair value of the asset group has the following components:
- (a) the value of the assets assuming their current use. This value differs from fair value when the current use of the assets is not their highest and best use. However, this value reflects all other factors market participants would consider when determining the price for the assets.
 - (b) the amount by which the fair value of the assets differs from their value in their current use (ie the incremental value of the asset group).
- 21 An entity shall recognise the incremental value described in paragraph 20(b) together with the asset to which it relates. Using the example in paragraph 20, the incremental value relates to the entity's ability to convert the land from its current use as an industrial property to its highest and best use as a residential property. Accordingly, the fair value of the land comprises its value assuming its current use plus the incremental value described in paragraph 20(b). The amount attributed to the factory reflects its current use as noted in paragraph 20(a). An entity shall account for the assets in accordance with the IFRSs applicable to those assets.

Application to assets: valuation premise

- 22 The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:
- (a) The highest and best use of the asset is 'in use' if the asset would provide maximum value to market participants principally through its use in combination with other assets and liabilities as a group (as installed or otherwise configured for use). If the highest and best use of the asset is

in use, the fair value of the asset shall be measured using an *in-use valuation premise*. When using an in-use valuation premise, the fair value of the asset is measured on the basis of the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets and liabilities as a group and that those assets and liabilities (complementary assets and liabilities) would be available to market participants. Assumptions about the highest and best use of the asset shall be consistent for all of the assets of the group within which it would be used.

- (b) The highest and best use of the asset is 'in exchange' if the asset would provide maximum value to market participants principally on a stand-alone basis. If the highest and best use of the asset is in exchange, the fair value of the asset shall be measured using an *in-exchange valuation premise*. Using an in-exchange valuation premise, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants who would use the asset on a stand-alone basis.
- 23 Because the highest and best use of the asset is determined on the basis of its use by market participants, fair value reflects the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.* Both the in-use valuation premise and the in-exchange valuation premise assume that the asset is sold individually, ie not as part of a group of assets or a business. However, the in-use valuation premise assumes that market participants will use the asset in combination with other assets or liabilities, and that those assets and liabilities are available to those market participants.
- 24 An entity shall use an in-exchange valuation premise when measuring the fair value of a financial asset. The fair value of a financial asset determined using the in-exchange valuation premise reflects any benefits that market participants would derive from holding that asset in a diversified portfolio. As a result, the in-use valuation premise is not relevant for financial assets.

Application to liabilities: general principles

- 25 A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability continues and the market participant transferee would be required to fulfil it; it is not settled with the counterparty or otherwise extinguished).
- 26 In many cases, there will not be an observable market price for the transfer of a liability. In such cases, an entity shall measure the fair value of a liability using the same methodology that the counterparty would use to measure the fair value of the corresponding asset.
- 27 If there is an active market for transactions between parties who hold debt securities as an asset, the observed price in that market also represents the fair value of the issuer's liability. An entity shall adjust the observed price for the asset for features that are present in the asset but not present in the liability, or vice versa. For example, in some cases the observed price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. In such cases, the objective is to estimate the fair value of the issuer's liability, not the price of the combined package. Thus, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement, a feature that is not present in the liability.
- 28 If there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity shall estimate the price that market participants would demand to assume the liability using present value techniques (see Appendix C) or other valuation techniques (see paragraphs 38–40). When using a present value technique, an entity must, among other things, estimate the future cash outflows that market participants would incur in fulfilling the obligation. An entity may estimate those future cash outflows by:
- (a) estimating the cash flows the entity would incur in fulfilling the obligation;
 - (b) excluding cash flows, if any, that other market participants would not incur; and
 - (c) including cash flows, if any, that other market participants would incur but the entity would not incur.

Although the technique is based, in part, on a settlement notion (ie cash flows incurred to fulfil the obligation), it produces the same price that would be paid to transfer a liability at the measurement

date, provided that technique is applied in a manner consistent with Appendix C. This is because a market participant transferee would assume the same obligation to fulfil the liability. An entity need not undertake exhaustive efforts to determine the cash flows in (b) and (c) above. However, an entity shall not ignore information about market participant assumptions that is reasonably available.

Application to liabilities: non-performance risk

- 29 The fair value of a liability reflects the effect of *non-performance risk*, which is the risk that an entity will not fulfil an obligation. Non-performance risk is assumed to be the same before and after the transfer of the liability. This is because market participants would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price. For example, a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor (debtor) if those terms reflect the transferor's lower credit standing.
- 30 Non-performance risk includes, but may not be limited to, an entity's own credit risk. When measuring the fair value of a liability, an entity shall consider the effect of its credit risk (credit standing) and any other risk factors that might influence the likelihood that the obligation will not be fulfilled. That effect may differ depending on the liability, eg whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability), and the terms of credit enhancements related to the liability, if any.

Application to liabilities: restrictions

- 31 A restriction on an entity's ability to transfer a liability to another party does not affect the fair value of the liability. This is because the fair value of a liability is a function of the requirement to fulfil the obligation. A market participant transferee would be required to fulfil the obligation and would take that into account when determining the price it would demand to assume the liability from the entity.

Application to equity instruments

- 32 As with assets and liabilities, the objective of a fair value measurement of an equity instrument is to estimate an exit price at the measurement date.
- 33 However, although the objective is the same, the issuer of an equity instrument can exit from that instrument only if the instrument ceases to exist or if the entity repurchases the instrument from the holder. For this reason, an entity shall measure the fair value of its equity instrument from the perspective of a market participant who holds the instrument as an asset.

Fair value at initial recognition

- 34 When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (often referred to as an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them. In some cases, eg in a business combination, there is not a transaction price for each individual asset or liability. Likewise, sometimes there is not an exchange transaction for the asset or liability, eg when biological assets regenerate.
- 35 Although conceptually entry prices and exit prices are different, in many cases an entry price of an asset or liability will equal the exit price (eg when on the transaction date the transaction to buy an asset would take place in the market in which the asset would be sold). In such cases, the fair value of an asset or liability at initial recognition equals the entry (transaction) price.
- 36 In determining whether fair value at initial recognition equals the transaction price, an entity shall consider factors specific to the transaction and the asset or liability. For example, the transaction price is the best evidence of the fair value of an asset or liability at initial recognition unless:
- (a) the transaction is between related parties.

- (b) the transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.
 - (c) the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that are separately measured or the transaction price includes transaction costs.
 - (d) the market in which the transaction takes place is different from the market in which the entity would sell the asset or transfer the liability, ie the most advantageous market. For example, those markets might be different if the entity is a securities dealer that transacts in different markets with retail customers (retail market) and with other securities dealers (inter-dealer market).
- 37 If an IFRS requires or permits an entity to measure an asset or liability initially at fair value and the transaction price differs from fair value, the entity recognises the resulting gain or loss in profit or loss unless the IFRS requires otherwise.

Valuation techniques

- 38 The objective of using a valuation technique is to estimate the price at which an orderly transaction would take place between market participants at the measurement date. Valuation techniques consistent with the market approach, income approach or cost approach shall be used to measure fair value. The main aspects of those approaches are summarised below:
- (a) The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering factors (qualitative and quantitative) specific to the measurement. Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but relying on the securities' relationship to other benchmark quoted securities.
 - (b) The income approach uses valuation techniques to convert future amounts (eg cash flows or income and expenses) to a single present (discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques (see Appendix C); option pricing models, such as the Black-Scholes-Merton formula (a closed form model) and a binomial model (a lattice model), which incorporate present value techniques and reflect both the time value and intrinsic value of an option; and the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.
 - (c) The cost approach reflects the amount that would currently be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence, and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives). The current replacement cost approach is generally appropriate for measuring the fair value of tangible assets using an in-use valuation premise because a market participant would not pay more for an asset than the amount for which it could replace the service capacity of that asset.
- 39 An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs. Periodically, an entity shall calibrate the valuation technique(s) used to prices from observable current market transactions in the same asset or liability (at initial recognition, this might be the transaction price). In some cases, a single valuation technique will

be appropriate (eg when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (eg as might be the case when valuing a cash-generating unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

- 40 Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (eg a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Inputs to valuation techniques

- 41 In this [draft] IFRS, 'inputs' refer broadly to the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, eg the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:
- (a) *Observable inputs* are inputs that are developed on the basis of available market data and reflect the assumptions that market participants would use when pricing the asset or liability.
 - (b) *Unobservable inputs* are inputs for which market data are not available and that are developed on the basis of the best information available about the assumptions that market participants would use when pricing the asset or liability.
- 42 Valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs. In some cases an entity may determine that observable inputs require significant adjustment based on unobservable data and thus the fair value measurement would be categorised in a lower level of the fair value hierarchy. For example, the entity may determine that an income approach valuation technique that maximises the use of relevant observable inputs and minimises the use of unobservable inputs is equally representative of fair value as (or more representative of fair value than) a market approach valuation technique that would require significant adjustments using unobservable inputs.

Fair value hierarchy

- 43 To increase consistency and comparability in fair value measurements and the related disclosures, this [draft] IFRS establishes a fair value hierarchy that prioritises into three levels (see paragraphs 45–54) the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs). In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised in different levels of the fair value hierarchy. 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. Assessing the significance of a particular input to the entire measurement requires judgement, considering factors specific to the asset or liability.
- 44 The availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level in the fair value hierarchy within which those inputs are categorised. If observable inputs require significant adjustment using unobservable inputs, the resulting measurement is a Level 3 measurement.

Level 1 inputs

- 45 *Level 1 inputs* are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- 46 Although an entity must have access to the market at the measurement date, it does not need to be able to sell the particular asset or transfer the particular liability on that date, eg if there is a restriction on the sale of the asset. However, the entity must be able to access the market when the restriction ceases to exist.
- 47 If a market participant would consider a restriction on the sale of an asset when determining the price for the asset, an entity shall adjust the quoted price to reflect the effect of that restriction. Such an adjustment is not a Level 1 input and, if the adjustment is significant, the measurement would be categorised in a lower level of the fair value hierarchy.
- 48 An active market for the asset or liability is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 49 and 50.
- 49 If an entity holds a large number of similar assets or liabilities (eg debt securities) that are measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, as a practical expedient, an entity may measure fair value using an alternative pricing method that does not rely exclusively on quoted prices (eg matrix pricing). However, the use of an alternative pricing method results in a lower level fair value measurement.
- 50 In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades or announcements) take place after the close of a market but before the measurement date. An entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment results in a lower level fair value measurement.

Level 2 inputs

- 51 *Level 2 inputs* are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices). 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:
- (a) quoted prices for similar assets or liabilities in active markets
 - (b) quoted prices for identical or similar assets or liabilities in markets that are not active (paragraph B5 provides examples of factors that may indicate that a market is not active)
 - (c) inputs other than quoted prices that are observable for the asset or liability (eg interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks and default rates)
 - (d) inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).
- 52 Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition or location of the asset, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the entire measurement might result in a Level 3 measurement, depending on where the inputs used to determine the adjustment are categorised in the fair value hierarchy.

Level 3 inputs

- 53 *Level 3 inputs* are inputs for the asset or liability that are not based on observable market data (unobservable inputs). Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, ie an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.
- 54 Unobservable inputs shall be developed using the best information available in the circumstances, which might include an entity's own data. In developing unobservable inputs, an entity may begin with its own data, which shall be adjusted if reasonably available information indicates that (a) other market participants would use different data or (b) there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy), and the entity is able to quantify these adjustments. An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall not ignore information about market participant assumptions that is reasonably available.

Inputs based on bid and ask prices

- 55 If an input used to measure fair value is based on bid and ask prices (eg in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where the input is categorised in the fair value hierarchy (Level 1, 2 or 3). This [draft] IFRS does not preclude the use of mid-market pricing or other pricing conventions used by market participants as a practical expedient for fair value measurements within a bid-ask spread. If a bid-ask spread for an asset or a liability is not observable directly or indirectly (eg a bid-ask spread for a similar asset or liability), an entity need not undertake exhaustive efforts to estimate a bid-ask spread.

Disclosures

- 56 **For assets and liabilities measured at fair value, an entity shall disclose information that enables users of its financial statements to assess the methods and inputs used to develop those measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.**
- 57 To meet the objectives in paragraph 56, an entity shall (except as otherwise specified below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, how much aggregation or disaggregation to undertake, and whether users need any additional information to evaluate the quantitative information disclosed. At a minimum, an entity shall disclose the following information for each class of assets and liabilities:
- (a) the fair value measurement at the end of the reporting period.
 - (b) the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).
 - (c) for assets and liabilities held at the reporting date, any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level shall be disclosed and discussed separately from transfers out of each level. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.
 - (d) the methods and the inputs used in the fair value measurement and the information used to develop those inputs. If there has been a change in valuation technique (eg changing from a market approach to an income approach), the entity shall disclose that change, the reasons for making it, and its effect on the fair value measurement.
 - (e) for fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:

- (i) total gains or losses for the period recognised in profit or loss, and a description of where they are presented in the statement of comprehensive income or the separate income statement (if presented).
 - (ii) total gains or losses for the period recognised in other comprehensive income.
 - (iii) purchases, sales, issues and settlements (each of those types of change disclosed separately).
 - (iv) transfers into or out of Level 3 (eg transfers attributable to changes in the observability of market data) and the reasons for those transfers. For significant transfers, transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.
- (f) the amount of the total gains or losses for the period in (e)(i) above included in profit or loss that are attributable to gains or losses relating to those assets and liabilities held at the reporting date, and a description of where those gains or losses are presented in the statement of comprehensive income or the separate income statement (if presented).
- (g) for fair value measurements categorised within Level 3 of the fair value hierarchy, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes. An entity shall disclose how it calculated those changes. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.
- 58 For each class of assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed, an entity shall disclose the fair value by the level of the fair value hierarchy.
- 59 For each class of liability measured at fair value after initial recognition, an entity shall disclose:
- (a) the amount of change, during the period and cumulatively, in the fair value of the liability that is attributable to changes in the non-performance risk of that liability, and the reasons for that change.
 - (b) how the entity estimated the amount in paragraph 59(a) attributable to changes in the non-performance risk of the liability.
 - (c) the difference between the liability's carrying amount and the amount of economic benefits the entity is required to sacrifice to satisfy the obligation (eg for a contractual liability, this would be the amount the entity is contractually required to pay to the holder of the obligation).
- 60 If an asset is used together with other assets and its highest and best use differs from its current use (see paragraphs 20 and 21), an entity shall disclose, by class of asset:
- (a) the value of the assets assuming their current use (ie the amount that would be their fair value if the current use were the highest and best use).
 - (b) the amount by which the fair value of the assets differs from their value in their current use (ie the incremental value of the asset group).
 - (c) the reasons the assets are being used in a manner that differs from their highest and best use.
- 61 An entity shall present the quantitative disclosures required by this [draft] IFRS in a tabular format unless another format is more appropriate.

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Appendix B

Application guidance

This appendix is an integral part of the [draft] IFRS.

The fair value measurement approach

- B1 The objective of a fair value measurement is to determine the price that would be received to sell an asset or paid to transfer a liability at the measurement date. A fair value measurement requires an entity to determine:
- (a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account).
 - (b) for an asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).
 - (c) the most advantageous market for the asset or liability.
 - (d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use in pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

In-use valuation premise

- B2 When measuring the fair value of a non-financial asset in use, the effect of using an in-use valuation premise depends on the circumstances. For example:
- (a) the fair value of the asset might be the same whether using an in-use or an in-exchange valuation premise. That might be the case if the asset is a business that market participants would continue to operate. In that case, the transaction would involve the business in its entirety. The use of the assets as a group in an ongoing business would generate synergies that would be available to market participants (market participant synergies).
 - (b) the in-use valuation premise might be incorporated in the fair value of the asset through adjustments to the value of the asset 'in exchange'. That might be the case if the asset is a machine and the fair value measurement is determined using an observed price for a similar machine (not installed or otherwise configured for use), adjusted for transport and installation costs so that the fair value measurement reflects the current condition and location of the machine (installed and configured for use).
 - (c) the in-use valuation premise might be incorporated into the fair value of the asset through the market participant assumptions used to measure the fair value of the asset. For example, if the asset is work-in-progress inventory that is unique and market participants would convert the inventory into finished goods, the fair value of the inventory would assume that market participants have or would acquire any specialised machinery necessary to convert the inventory into finished goods.
 - (d) the in-use valuation premise might be incorporated into the valuation technique used to measure the fair value of the asset. That might be the case when using the multi-period excess earnings method to measure the fair value of some intangible assets because that valuation technique specifically considers the contribution of any complementary assets in the group in which such an intangible asset would be used.
 - (e) in more limited situations, when an entity uses an asset within a group of assets, the entity might measure the asset at an amount that approximates its fair value in use when allocating the fair value of the asset group to the individual assets of the group. That might be the case if the valuation involves real property and the fair value of improved property (an asset group) is allocated to its component assets (such as land and improvements).

Fair value hierarchy

Level 2 input

B3 Examples of Level 2 inputs for particular assets and liabilities follow.

- (a) *Receive-fixed, pay-variable interest rate swap based on the LIBOR swap rate.* A Level 2 input would include the LIBOR swap rate if that rate is observable at commonly quoted intervals for the full term of the swap.
- (b) *Receive-fixed, pay-variable interest rate swap based on a foreign-denominated yield curve.* A Level 2 input would include the swap rate based on a foreign-denominated yield curve that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for year 10 would not be significant to the fair value measurement of the swap in its entirety.
- (c) *Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate.* A Level 2 input would include the bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.
- (d) *Three-year option on exchange-traded shares.* A Level 2 input would include the implied volatility for the shares derived through extrapolation to year 3 if (i) prices for one-year and two-year options on the shares are observable and (ii) the extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option. In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one-year and two-year implied volatilities is established.
- (e) *Licensing arrangement.* For a licensing arrangement that is acquired in a business combination and was recently negotiated with an unrelated party by the acquired entity (the party to the licensing arrangement), a Level 2 input would include the royalty rate at inception of the arrangement.
- (f) *Finished goods inventory at a retail outlet.* For finished goods inventory that is acquired in a business combination, a Level 2 input would include either a price to customers in a retail market or a wholesale price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments shall be used for the fair value measurement.
- (g) *Building held and used.* A Level 2 input would include the price per square metre for the building (a valuation multiple) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (similar) buildings in similar locations.
- (h) *Cash-generating unit.* A Level 2 input would include a valuation multiple (eg a multiple of earnings or revenue or a similar performance measure) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (similar) businesses, considering operational, market, financial and non-financial factors.

Level 3 inputs

B4 Examples of Level 3 inputs for particular assets and liabilities follow.

- (a) *Long-dated currency swap.* A Level 3 input would include interest rates in a specified currency that are not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.

- (b) *Three-year option on exchange-traded shares.* A Level 3 input would include historical volatility, ie the volatility for the shares derived from the shares' historical prices. Historical volatility typically does not represent current market participant expectations about future volatility, even if it is the only information available to price an option.
- (c) *Interest rate swap.* A Level 3 input would include an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.
- (d) *Decommissioning liability assumed in a business combination.* A Level 3 input would include a current estimate of the cash outflows to be paid to fulfil the obligation developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions. That Level 3 input would be used in a present value technique together with other inputs, eg (i) a current risk-free discount rate that adjusts the estimated future cash outflows for the time value of money or a credit-adjusted risk-free rate if the effect of the entity's credit standing on the fair value of the liability is reflected in the discount rate rather than in the estimate of future cash outflows and (ii) an estimate of the premium, if any, that market participants would require for bearing risk arising from the obligation (the risk premium) and to generate the profit they would require for undertaking to fulfil the obligation. The risk premium takes into account the uncertainty inherent in the estimate of the future cash outflows (ie the price market participants would require for bearing the risk of possible variations in the amount or timing of the cash flows).
- (e) *Cash-generating unit.* A Level 3 input would include a financial forecast (eg of cash flows or profit or loss) developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions.

Not active markets and transactions that are not orderly

B5 The presence of the following factors may indicate that a market is not active:

- (a) there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities).
- (b) there are few recent transactions.
- (c) price quotations are not based on current information.
- (d) price quotations vary substantially over time or among market-makers (eg some brokered markets).
- (e) indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- (f) there is a significant increase in implied liquidity risk premiums, yields or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the entity's estimate of expected cash flows, considering all available market data about credit and other non-performance risk for the asset or liability.
- (g) there is a wide bid-ask spread or significant increase in the bid-ask spread.
- (h) there is a significant decline or absence of a market for new issues (ie primary market) for the asset or liability (or similar assets or liabilities).
- (i) little information is released publicly (eg a principal-to-principal market).

An entity evaluates the significance and relevance of the factors (together with other pertinent factors) to determine whether, on the basis of the evidence available, a market is not active.

B6 If an entity concludes that a market is not active, transactions or quoted prices in that market may not be determinative of fair value (eg there may be transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to measure fair value. Significant adjustments also may be necessary in other circumstances (eg when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

- B7 This [draft] IFRS does not prescribe a methodology for making significant adjustments to transactions or quoted prices. Paragraphs 38–40 discuss the use of valuation techniques when measuring fair value. Regardless of the valuation technique used, an entity includes appropriate risk adjustments, including a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) inherent in the cash flows of an asset or liability (see paragraph C5). Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment. The risk premium should be reflective of an orderly transaction between market participants at the measurement date under current market conditions.
- B8 If a market is not active, a change in valuation technique or the use of multiple valuation techniques may be appropriate (eg the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, an entity considers the reasonableness of the range of fair value estimates. The objective is to determine the point within the range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.
- B9 Even when a market is not active, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (ie not a forced liquidation or distress sale) between market participants at the measurement date under current market conditions.
- B10 Measuring fair value in a market that is not active depends on the facts and circumstances and requires the use of significant judgement. An entity's intention to continue to hold the asset or liability is not relevant when measuring fair value because fair value is a market-based measurement, not an entity-specific measurement.
- B11 Even if a market is not active, it is not appropriate to conclude that all transactions in that market are not orderly (ie are forced or distress sales). Circumstances that may indicate that a transaction is not orderly include, but are not limited to the following:
- (a) there was not adequate 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 under current market conditions.
 - (b) there was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
 - (c) the seller is in or near bankruptcy or receivership (ie distressed) or the seller was required to sell to meet regulatory or legal requirements (ie forced).
 - (d) the transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability. An entity evaluates the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly.
- B12 If the evidence indicates that a transaction is not orderly, an entity places little, if any, weight (compared with other indications of fair value) on that transaction price when measuring fair value or estimating market risk premiums.
- B13 If the evidence indicates that a transaction is orderly, an entity considers that transaction price when measuring fair value or estimating market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the size of the transaction, the comparability of the transaction to the asset or liability being measured and the proximity of the transaction to the measurement date.
- B14 If an entity does not have sufficient information to conclude whether a transaction is orderly, it considers the transaction price when measuring fair value or estimating market risk premiums. However, that transaction price may not be determinative of fair value (ie the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When an entity does not have sufficient information to conclude whether particular transactions are orderly, the entity places less weight on those transactions.

- B15 An entity need not undertake exhaustive efforts to determine whether a transaction is orderly but it shall not ignore information that is reasonably available. When an entity is a party to a transaction it is presumed to have sufficient information to conclude whether the transaction is orderly.

Quoted prices provided by third parties

- B16 When an entity is measuring fair value, this [draft] IFRS does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the entity has determined that the quoted prices provided by those parties are determined in accordance with this [draft] IFRS.
- B17 If a market is not active, an entity must evaluate whether the quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, an entity places less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions.
- B18 Furthermore, the nature of a quote (eg whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

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Appendix C

Present value techniques

This appendix is an integral part of the [draft] IFRS.

Introduction

- C1 This appendix provides information about using present value techniques to measure fair value. This guidance focuses on a traditional or discount rate adjustment technique and an expected cash flow (expected present value) technique. This guidance neither prescribes the use of one specific present value technique nor limits the use of present value techniques to measure fair value to the techniques discussed. The present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (eg whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data.

The components of a present value measurement

- C2 Present value (an application of the income approach) is a tool used to link uncertain future amounts (cash flows or values) to a present amount using a discount rate that is consistent with value maximising behaviour. A fair value measurement of an asset or liability, using present value, shall capture the following elements from the perspective of market participants at the measurement date:
- (a) an estimate of future cash flows for the asset or liability being measured
 - (b) expectations about possible variations in the amount and/or timing of the cash flows representing the uncertainty inherent in the cash flows
 - (c) the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (risk-free interest rate)
 - (d) the price for bearing the uncertainty inherent in the cash flows (risk premium)
 - (e) other factors that would be considered by market participants in the circumstances.

General principles

- C3 Present value techniques differ in how they capture those elements. However, the following general principles govern the application of any present value technique used to estimate fair value:

- (a) Cash flows and discount rates shall reflect assumptions that market participants would use when pricing the asset or liability.
- (b) Cash flows and discount rates shall consider only the features of the asset or liability being measured.
- (c) To avoid double-counting or omitting the effects of risk factors, discount rates shall reflect assumptions that are consistent with those inherent in the cash flows.*
- (d) Assumptions about cash flows and discount rates shall be internally consistent. For example, nominal cash flows (that include the effect of inflation) shall be discounted at a rate that includes the effect of inflation. The nominal risk-free interest rate includes the effect of inflation. Real cash flows (that exclude the effect of inflation) shall be discounted at a rate that excludes the effect of inflation. Similarly, after-tax cash flows shall be discounted using an after-tax discount rate. Pre-tax cash flows shall be discounted at a rate consistent with those cash flows.
- (e) Discount rates shall be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

Risk and uncertainty

- C4 A fair value measurement, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, both the amount and timing of the cash flows will be uncertain. Even contractually fixed amounts, such as the payments on a loan, will be uncertain if there is risk of default. For example, a discount rate that reflects expectations about future defaults is appropriate if using contractual cash flows of a loan (discount rate adjustment technique). That same rate would not be used if using expected (probability-weighted) cash flows (expected present value technique) because the expected cash flows already reflect assumptions about future defaults; instead, a discount rate that is commensurate with the risk inherent in the expected cash flows shall be used.
- C5 Risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement shall include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not sufficient reason to exclude a risk adjustment.
- C6 Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example:
 - (a) the discount rate adjustment technique (see paragraphs C7–C11) uses contractual, promised or most likely cash flows and a discount rate that includes an adjustment for both (i) the effect of the difference between those cash flows and the expected cash flows and (ii) the risk premium that market participants require for bearing the risk that the actual cash flows may ultimately differ from the expected cash flows.
 - (b) Method 1 of the expected present value technique (see paragraph C14) uses risk-adjusted expected cash flows and a risk-free rate.
 - (c) Method 2 of the expected present value technique (see paragraph C15) uses expected cash flows and a discount rate adjusted to include the risk premium that market participants require (this rate is different from the rate used in the discount rate adjustment technique).

Discount rate adjustment technique

- C7 The discount rate adjustment technique uses a single set of cash flows from the range of possible estimated amounts, whether contractual or promised (as is the case for a bond) or most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events (eg contractual or promised cash flows for a bond are conditional on the event of no default by the debtor). The discount rate used in the discount rate adjustment technique is derived from observed rates of return for comparable assets or liabilities that are traded in the market. Accordingly, the

contractual, promised or most likely cash flows are discounted at an observed or estimated market rate for such conditional cash flows (market rate of return).

- C8 The discount rate adjustment technique requires an analysis of market data for comparable assets or liabilities. Comparability is established by considering the nature of the cash flows (eg whether the cash flows are contractual or non-contractual and are likely to respond similarly to changes in economic conditions), as well as other factors (eg credit standing, collateral, duration, restrictive covenants and liquidity). Alternatively, if a single comparable asset or liability does not fairly reflect the risk inherent in the cash flows of the asset or liability being measured, it may be possible to derive a discount rate using data for several comparable assets or liabilities in conjunction with the risk-free yield curve (a 'build-up' approach).
- C9 To illustrate a build-up approach, assume that Asset A is a contractual right to receive CU800* in one year (no timing uncertainty). There is an established market for comparable assets, and information about those assets, including price information, is available. Of those comparable assets:
- (a) Asset B is a contractual right to receive CU1,200 in one year and has a market price of CU1,083. Thus, the implied annual rate of return (one-year market rate of return) is 10.8 per cent $[(CU1,200/CU1,083) - 1]$.
 - (b) Asset C is a contractual right to receive CU700 in two years and has a market price of CU566. Thus, the implied annual rate of return (two-year market rate of return) is 11.2 per cent $[(CU700/CU566)^{0.5} - 1]$.
 - (c) All three assets are comparable as regards risk (dispersion of possible pay-offs and credit).
- C10 On the basis of the timing of the contractual payments to be received for Asset A (one year for Asset B versus two years for Asset C), Asset B is deemed more comparable to Asset A. Using the contractual payment to be received for Asset A (CU800) and the one-year market rate derived from Asset B (10.8 per cent), the fair value of Asset A is CU722 (CU800/1.108). Alternatively, in the absence of available market information for Asset B, the one-year market rate could be derived from Asset C using the build-up approach. In that case, the two-year market rate indicated by Asset C (11.2 per cent) would be adjusted to a one-year market rate using the term structure of the risk-free yield curve. Additional information and analysis * In this [draft] IFRS monetary amounts are denominated in 'currency units (CU)' might also be required to determine whether the risk premium for one-year and two-year assets is the same. If it is determined that the risk premium for one-year and two-year assets is not the same, the two-year market rate of return would be further adjusted for that effect.
- C11 In applying the discount rate adjustment technique to fixed claims, the adjustment for risk inherent in the cash flows of the asset or liability being measured is included in the discount rate. In some applications of the discount rate adjustment technique to cash flows that are not fixed claims, an adjustment to the cash flows also may be necessary to achieve comparability with the observed asset or liability from which the discount rate is derived.

Expected present value technique

- C12 The expected present value technique uses as a starting point a set of cash flows that, in theory, represents the probability-weighted average of all possible cash flows (expected cash flows). The resulting estimate is identical to expected value, which, in statistical terms, is the weighted average of a random variable's possible values where the respective probabilities are used as weights. Because all possible cash flows are probability-weighted, the resulting expected cash flow is not conditional upon the occurrence of any specified event (unlike the cash flows used in the discount rate adjustment technique).
- C13 In making an investment decision, risk-averse market participants would consider the risk that the actual cash flows may ultimately differ from the expected cash flows. Portfolio theory distinguishes between two types of risk. The first is risk specific to a particular asset or liability, also referred to as unsystematic (diversifiable) risk. The second is general market risk, also referred to as systematic (non-diversifiable) risk. The systematic or non-diversifiable risk of an asset (or liability) refers to the amount by which the asset (or liability) increases the variance of a diversified portfolio when it is added to that portfolio. Portfolio theory holds that in a market in equilibrium, market participants will be compensated only for bearing the systematic or non-diversifiable risk inherent in the cash

flows. (In markets that are inefficient or out of equilibrium, other forms of return or compensation might be available.)

- C14 Method 1 of the expected present value technique adjusts the expected cash flows for the systematic (market) risk by subtracting a cash risk premium (risk-adjusted expected cash flows). These risk-adjusted expected cash flows represent a certainty-equivalent cash flow, which is discounted at a risk-free interest rate. A certainty-equivalent cash flow refers to an expected cash flow (as defined), adjusted for risk so that a market participant is indifferent to trading a certain cash flow for an expected cash flow. For example, if a market participant were willing to trade an expected cash flow of CU1,200 for a certain cash flow of CU1,000, the CU1,000 is the certainty equivalent of the CU1,200 (the CU200 would represent the cash risk premium). In that case, the market participant would be indifferent as to the asset held.
- C15 In contrast, Method 2 of the expected present value technique adjusts for systematic (market) risk by adding a risk premium to the risk-free interest rate. Accordingly, the expected cash flows are discounted at a rate that corresponds to an expected rate associated with probability-weighted cash flows (expected rate of return). Models used for pricing risky assets, such as the Capital Asset Pricing Model, can be used to estimate the expected rate of return. Because the discount rate used in the discount rate adjustment technique is a rate of return relating to conditional cash flows, it is likely to be higher than the discount rate used in Method 2 of the expected present value technique, which is an expected rate of return relating to expected or probability-weighted cash flows.
- C16 To illustrate Methods 1 and 2, assume that an asset has expected cash flows of CU780 in one year based on the possible cash flows and probabilities shown below. The applicable risk-free interest rate for cash flows with a one-year horizon is 5 per cent, and the systematic risk premium for an asset with the same risk profile is 3 per cent.

Possible cash flows	Probability	Probability-weighted cash flows
CU500	15%	CU75
CU800	60%	CU480
CU900	25%	CU225
Expected cash flows		CU780

- C17 In this simple illustration, the expected cash flows (CU780) represent the probability-weighted average of the three possible outcomes. In more realistic situations, there could be many possible outcomes. However, it is not always necessary to consider distributions of literally all possible cash flows using complex models and techniques to apply the expected present value technique. Rather, it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows. For example, an entity might use realised cash flows for some relevant past period, adjusted for changes in circumstances occurring subsequently (eg changes in external factors, including economic or market conditions, industry trends and competition as well as changes in internal factors affecting the entity more specifically), considering the assumptions of market participants.
- C18 In theory, the present value (fair value) of the asset's cash flows is the same (CU722) whether determined under Method 1 or Method 2, as indicated below. Specifically:
- (a) under Method 1, the expected cash flows are adjusted for systematic (market) risk. In the absence of market data directly indicating the amount of the risk adjustment, such adjustment could be derived from an asset pricing model using the concept of certainty equivalents. For example, the risk adjustment (cash risk premium of CU22) could be determined using the systematic risk premium of 3 per cent ($CU780 - [CU780 \times (1.05/1.08)]$), which results in risk-adjusted expected cash flows of CU758 ($CU780 - CU22$). The CU758 is the certainty equivalent of CU780 and is discounted at the risk-free interest rate (5 per cent). The present value (fair value) of the asset is CU722 ($CU758/1.05$).

- (b) under Method 2, the expected cash flows are not adjusted for systematic (market) risk. Rather, the adjustment for that risk is included in the discount rate. Thus, the expected cash flows are discounted at an expected rate of return of 8 per cent (the 5 per cent risk-free interest rate plus the 3 per cent systematic risk premium). The present value (fair value) of the asset is CU722 (CU780/1.08).

C19 When using an expected present value technique to measure fair value, either Method 1 or Method 2 could be used. The selection of Method 1 or Method 2 will depend on facts and circumstances specific to the asset or liability being measured, the extent to which sufficient data are available and the judgements applied.