# HKFRS 13 *Fair Value Measurement*

**HKICPA Standard Setting Department Staff Summary (June 2011)**

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## Introduction

1. HKFRS 13 *Fair Value Measurement* improves consistency and reduces complexity by providing a precise definition of fair value and a single source of fair value measurement and disclosure requirements for use across HKFRSs.

2. Entities are required to apply HKFRS 13 for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

## Reasons for issuing HKFRS 13

3. The objective of the Hong Kong Institute of Certified Public Accountants (HKICPA) in issuing HKFRS 13 is to maintain international convergence arising from the issuance of IFRS 13 by the International Accounting Standards Board's (IASB).

4. Some HKFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments. Because those HKFRSs were developed over many years, the requirements for measuring fair value and for disclosing information about fair value measurements were dispersed and in many cases did not articulate a clear measurement or disclosure objective.

5. As a result, some of those HKFRSs contained limited guidance about how to measure fair value, whereas others contained extensive guidance and that guidance was not always consistent across those HKFRs that refer to fair value. Inconsistencies in the requirements for measuring fair value and for disclosing information about fair value measurements have contributed to diversity in practice and have reduced the comparability of information reported in financial statements. HKFRS 13 remedies that situation.

## Main features of HKFRS 13

6. HKFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

7. That definition of fair value emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:

   a. The condition and location of the asset; and
   b. Restrictions, if any, on the sale or use of the asset.

8. A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:

   a. In the principal market for the asset or liability (that is, the market with the greatest volume and level of activity for the asset or liability); or
   b. In the absence of a principal market, in the most advantageous market for the asset or liability (that is, the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs).

9. Market participant are buyers and sellers in the principal (or most advantageous) market for the asset or liability who are independent of each other, knowledgeable, and are able and willing to enter into a transaction for the asset or liability.

10. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

11. 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 (for example, a forced liquidation or distress sale).

12. The fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability. However, even if a market is not active, it is not appropriate to conclude that all transactions in that market are not orderly.

13. The price used to measure the fair value of the asset or liability shall not be adjusted for transaction costs as transaction costs are not a characteristic of an asset or a liability.

14. For a non-financial asset, its fair value measurement takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

15. A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument is transferred to a market participant at the measurement date, but would remain outstanding.

16. When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date, while an entity shall use a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity when the identical item is not held by another party as an asset.

17. Moreover, the fair value of a liability reflects the effect of non-performance risk. Non-performance risk includes, but may not be limited to, an entity's own credit risk.

18. If the entity manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the entity is permitted to apply an exception to measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date, given that certain criteria are met.

19. To be able to use that exception, an entity needs to provide evidence that it manages its financial instruments on the basis of its net exposure to those risks on a consistent basis, the market risks being offset must be substantially the same and, in the case of credit risk, there must be an arrangement with the counterparty that mitigates credit risk exposure in the event of default.

20. An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. HKFRS 13 describes three different valuation techniques that may be used to measure fair value:

    a. Market approach – The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities or a group of assets and liabilities, such as a business;
    b. Cost approach – The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (that is, current replacement cost); and
    c. Income approach – The income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount.

    An entity shall use valuation technique consistent with one or more of those approaches to measure fair value.

21. An entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability. In some cases those characteristics result in the application of an adjustment, such as a premium or discount. Premiums or discounts that reflect size

as a characteristic of the entity's holding (specifically, a blockage factor) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement.

22. To increase consistency and comparability in fair value measurements and related disclosures, HKFRS 13 establishes a fair value hierarchy that categorises into three levels the inputs to valuation techniques used to measure fair value:

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

23. An entity shall disclose information that helps users of its financial statements assess both of the following:

   a. For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.
   b. For recurring 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.

24. The main aspects of the disclosure requirements for fair value measurements categorized within Level 3 of the fair value hierarchy include the following:

   a. Reconciliation from opening to closing balances;
   b. Quantitative information about the significant inputs used in the valuation technique(s);
   c. Valuation processes used by the entity; and
   d. Sensitivity to changes in significant unobservable inputs (a narrative discussion for all fair value measurements and a quantitative analysis for financial instruments).

**<u>Other references on HKFRS 13/IFRS 13</u>**

1. Deloitte IFRS in Focus on IFRS 13

   http://www.iasplus.com/iasplus/1105ifrs13.pdf

2. Ernst & Young 'IFRS Developments' on fair value measurement guidance converges

   http://www.ey.com/Publication/vwLUAssets/IFRS_Developments_Issue_2/$File/IFRS_Developments_Issue_2_GL_IFRS.pdf

3 Ernst & Young 'IFRS 13 Fair value measurement – Implications for the real estate and construction industries'

http://www.ey.com/Publication/vwLUAssets/IFRS_13_fair_value_measurement_real_estate/$FILE/IFRS_13_fair_value_measurement_real_estate_values_GL_IFRS.pdf

4 KPMG 'In the Headlines' on unified fair value measurement and disclosure guidance for IFRS

http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/In-the-headlines/Documents/In-the-headlines-O-201105-17.pdf

5 KPMG 'First Impressions: Fair value measurement'

http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/First-Impressions/Documents/First-Impressions-O-1106-Fair-value-measurement.pdf

6 PricewaterhouseCoopers 'IFRS news'

http://www.pwc.com/en_GX/gx/ifrs-reporting/pdf/IFRS_news_-_June_FINAL.pdf

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