

May 2011

Project Summary and Feedback Statement

Agenda Paper 6b

IFRS 13 *Fair Value Measurement*

At a glance

We, the International Accounting Standards Board (IASB), issued IFRS 13 *Fair Value Measurement* in May 2011. IFRS 13 defines fair value, sets out in a single IFRS a framework for measuring fair value and requires disclosures about fair value measurements.

IFRS 13 is effective from 1 January 2013. Early application is permitted.

IFRS 13 applies when other IFRSs require or permit fair value measurements.

It does not introduce any new requirements to measure an asset or a liability at fair value, change what is measured at fair value in IFRSs or address how to present changes in fair value.

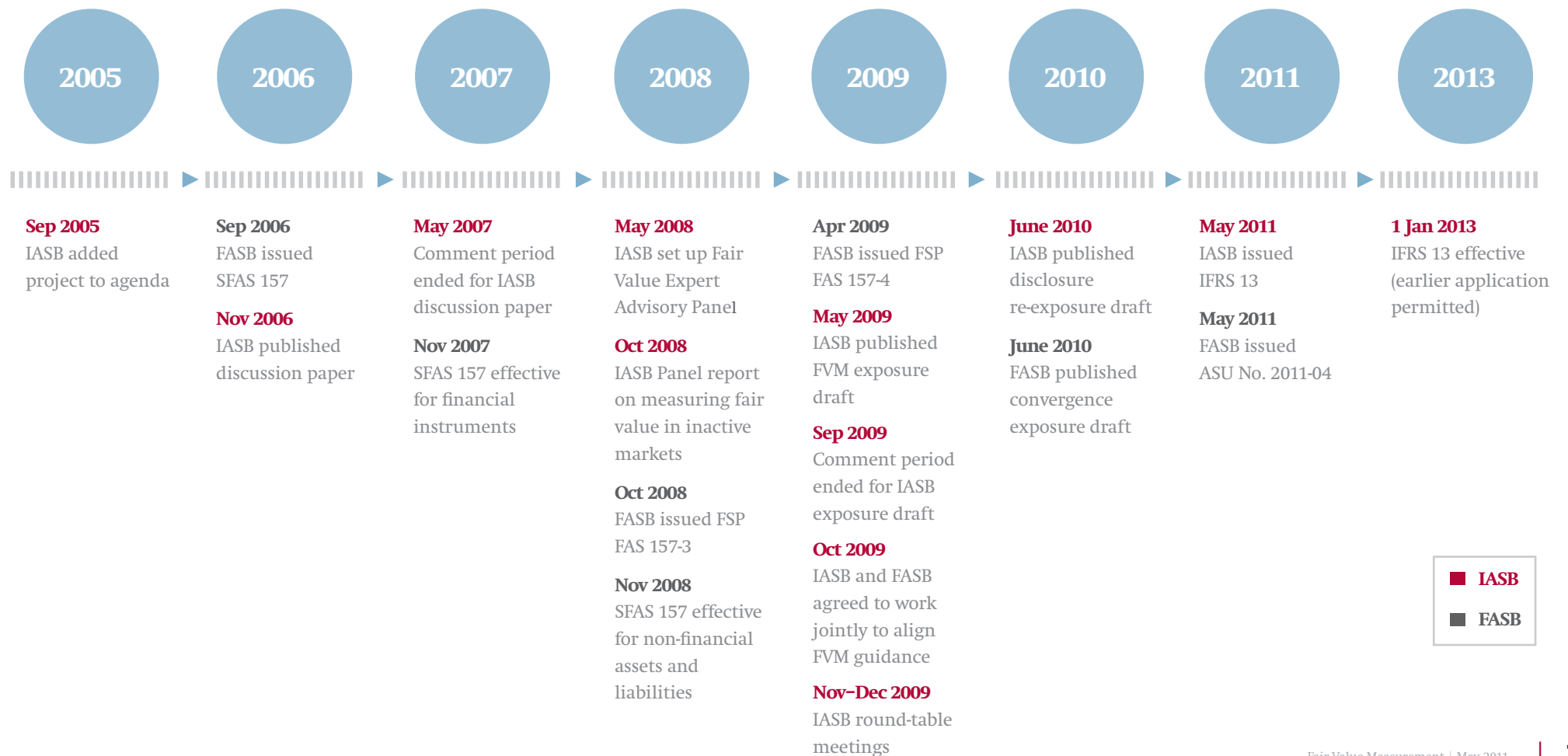
We began the project in 2005 as part of our joint efforts with the US national standard-setter, the Financial Accounting Standards Board (FASB), to create a common set of high quality global accounting standards.

The project was part of the Memorandum of Understanding (MoU) between the boards. As a result of our joint work, we aligned International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) in this important area of accounting. The new requirements result in IFRSs and US GAAP having the same definition and meaning of fair value and the same disclosure requirements about fair value measurements.

Having the same fair value measurement and disclosure requirements will reduce diversity in application, which will improve the comparability of financial statements prepared using IFRSs and those using US GAAP.

The global financial crisis emphasised the importance of having common fair value measurement and disclosure requirements—with identical wording—in IFRSs and US GAAP. IFRS 13 provides clear and consistent guidance for measuring fair value and addressing valuation uncertainty in markets that are no longer active. It also increases the transparency of fair value measurements by requiring detailed disclosures about fair values derived using models.

Project time line



Why we undertook this project

Some IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments.

Because we (and our predecessor body) developed those standards over many years, the requirements for measuring fair value and for disclosing information about fair values were dispersed across many standards and in many cases those standards did not articulate a clear measurement or disclosure objective.

As a result, some IFRSs contained limited information about how to measure fair value, whereas others contained extensive information, which was not always consistent across the standards.

The goals of the fair value measurement project were:

- to reduce complexity and improve consistency in the application of fair value measurement principles by having a single set of requirements for all fair value measurements;
- to communicate the measurement objective more clearly by clarifying the definition of fair value;
- to improve transparency by enhancing disclosures about fair value measurements; and
- to increase the convergence of IFRSs and US GAAP.

Responding to the global financial crisis

Although the fair value measurement project was added to our agenda before the global financial crisis began, the crisis emphasised the importance of having common fair value measurement and disclosure requirements in IFRSs and US GAAP.

In particular, the global financial crisis highlighted the need for:

- clarifying how to measure fair value when the market for an asset or liability becomes less active; and
- improving the transparency of fair value measurements through disclosures about measurement uncertainty.

Consistently with the recommendations of the Group of Twenty (G20) Leaders, the Financial Stability Board and the IASB's and FASB's Financial Crisis Advisory Group (FCAG), we worked with the FASB to address those issues.

In May 2008 we established a Fair Value Expert Advisory Panel that included preparers, auditors and users of financial statements, as well as regulators.

The Panel's remit was to help us:

- review best practices in the area of valuation techniques; and
- formulate any necessary additional practice guidance on valuation methods for financial instruments and related disclosures when markets are no longer active.

In October 2008 our staff published a report summarising the Panel's discussions. The report, *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*, summarised the valuation and disclosure practices undertaken by large financial institutions in the financial crisis. The requirements in IFRS 13 are consistent with that report.

IFRS 13 will help increase transparency when entities use models to measure fair value, particularly when users need more information about measurement uncertainty, such as when the market for an asset or a liability has become less active.

Providing additional information about Level 3 fair value measurements to users of financial statements will help improve confidence in those measurements.

IFRS 13 requires entities to disclose information about the valuation techniques and inputs used to measure fair value, as well as information about the uncertainty inherent in fair value measurements (which was of particular concern during the global financial crisis).

Some of those disclosures, including the fair value hierarchy, were already introduced in March 2009 through an amendment to IFRS 7 *Financial Instruments: Disclosures*. Those disclosures have been relocated to IFRS 13.

The requirements in IFRS 13 also incorporate the guidance in a FASB Staff Position (FSP) issued in April 2009.

Fair value hierarchy

Level 1	Quoted prices in active markets for identical assets and liabilities. Level 1 inputs must be used without adjustment whenever available.
Level 2	Inputs not included within Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3	Unobservable inputs, including the entity's own data, which are adjusted if necessary to reflect market participants' assumptions.

Summary of the main changes from the exposure draft

Exposure draft proposal	IFRS 13 requirement
Fair value is measured using the price in the most advantageous market for the asset or liability (ie 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).	We changed the requirement. Fair value is measured using the price in the principal market for the asset or liability (ie the market with the greatest volume and level of activity for the asset or liability) or, in the absence of a principal market, the most advantageous market for the asset or liability.
High level guidance for measuring the fair value of liabilities.	We added more guidance. Detailed guidance for measuring the fair value of liabilities, including a description of the compensation that market participants would demand to take on an obligation.
Financial assets are measured on an individual instrument basis (using the in-exchange valuation premise).	We made the guidance more explicit. Financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk can be measured on the basis of the entity's net risk exposure.
No guidance on determining classes of assets or liabilities for disclosure purposes.	We added more guidance. Classes of assets or liabilities for disclosure purposes are determined on the basis of the nature, characteristics and risks of the asset or liability and the level of the fair value hierarchy (ie Level 1, 2 or 3) within which the fair value measurement is categorised.

Exposure draft proposal	IFRS 13 requirement
<p>A quantitative sensitivity analysis is required for all assets and liabilities categorised within Level 3 of the fair value hierarchy, with no corresponding narrative discussion.</p>	<p>We changed the requirement. A narrative discussion is required about the sensitivity of a fair value measurement categorised within Level 3 of the fair value hierarchy to changes in significant unobservable inputs and any interrelationships between those inputs that might magnify or mitigate the effect on the measurement. In addition, a quantitative sensitivity analysis is required for financial instruments measured at fair value.</p>
<p>No requirement to provide information about an entity's valuation processes (eg how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period).</p>	<p>We added a requirement. Information about an entity's valuation processes is required for fair value measurements categorised within Level 3 of the fair value hierarchy. That disclosure is similar to the description of valuation processes in the Fair Value Expert Advisory Panel's report in October 2008.</p>

Enhancing comparability with US GAAP

The updated 2006 MoU with the FASB included fair value measurement with the goal of improving and aligning the requirements. To achieve that goal, we began developing IFRS 13 by publishing a discussion paper in November 2006 that used the US GAAP requirements in SFAS 157 as the basis for forming our preliminary views.

Not all of our preliminary views were in line with the requirements in SFAS 157. As a result, some of the proposals in our exposure draft were different from the requirements in US GAAP and some proposals used different words to express the same requirements.

Given the differences between our proposals and the requirements in US GAAP, one of the most prevalent responses to the exposure draft was that we and the FASB should work to have the same requirements in IFRSs and US GAAP for measuring fair value and for disclosing information about those measurements (with identical wording to the greatest extent possible).

In response to that comment, the fair value measurement project became a joint project with the FASB in October 2009 and the FASB agreed to amend Topic 820 as necessary.

As a result of our joint efforts, IFRSs and US GAAP now have the same definition of fair value and the measurement and disclosure requirements are now aligned. However, some differences remain:

- There are some different disclosure requirements about fair value measurements. For example, IFRSs require a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorised within Level 3 of the fair value hierarchy (that disclosure was previously in IFRS 7), whereas US GAAP does not require a quantitative sensitivity analysis disclosure.
- There are different requirements about whether, and in what circumstances, an entity with an investment in an investment company may use the reported net asset value as a measure of fair value.

Outreach activities

We consulted interested parties extensively throughout the process that resulted in IFRS 13.

In addition to the comment letters received on the discussion paper and exposure draft, the main sources of feedback included the following:

- To ensure a thorough understanding of the views of **investors and other users of financial statements**, we had face-to-face meetings and conference calls and we conducted a user survey. In particular, we discussed how the fair value measurement disclosures in IFRSs and US GAAP could be improved. Those discussions focused on the need to align the wording of the requirements to improve consistency in application across jurisdictions, as well as the usefulness of existing disclosures. In particular, we sought their input about the fair value sensitivity analysis disclosure in IFRS 7, how it could be improved and any other information that could be useful for assessing the inherent subjectivity in fair value measurements categorised within Level 3 of the fair value hierarchy.
- We also held discussions with **preparers** and **auditors** of financial statements, as well as **regulators**, about how they prepare, audit and use fair value information in IFRSs and US GAAP.
- In 2010 we held discussions with **financial institutions** about their risk management practices and how those practices affect the valuation of financial instruments held within a portfolio. Those discussions formed the basis of the guidance for measuring the fair value of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk.

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- In December 2009 we published a Request for Input asking **entities in emerging and transition economies** to consider whether the proposed fair value measurement guidance could be applied in their jurisdiction. That feedback helped us see the need for the IFRS Foundation to publish educational material to accompany IFRS 13. That educational material will be published after IFRS 13 is issued.
 - In November and December 2009 we held **round-table meetings** in Asia, Europe and the US to seek views on the proposals in the exposure draft. Participants in the round-table meetings included preparers, auditors and users of financial statements. In addition, at that time we held round-table meetings in Singapore and Kuala Lumpur. Those round-table meetings offered participants a chance to express their concerns about the application of the proposals in the exposure draft to entities in emerging and transition economies.
 - In March 2008 we set up a **Fair Value Expert Advisory Panel** to address concerns raised in the recent global financial crisis about how to measure fair value when the market activity for an asset or a liability declines and how to increase transparency about those measurements.
 - In February 2008 we asked interested parties (including preparers, auditors and users of financial statements) to take part in the **standard-by-standard review** of whether fair value, as used in IFRSs, is consistent with an exit price measurement objective and the related measurement guidance. That helped us determine the scope of IFRS 13.
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Our due process

Our Due Process Handbook describes the steps that we need to consider before publishing an exposure draft or issuing an IFRS or an amendment to an existing IFRS. Before we issued IFRS 13, our Trustees' Due Process Oversight Committee reviewed compliance with the due process steps.

Discussion paper

Although not a mandatory step in our due process, we published a discussion paper outlining our preliminary views on fair value measurement to understand whether our stakeholders:

- would find the then recently-issued US standard on fair value measurement (SFAS 157) an improvement on the existing fair value measurement guidance in IFRSs; and
- thought SFAS 157 was a good starting point for our deliberations.

We published the discussion paper in November 2006 with a six-month comment period. We received 136 comment letters.

Working groups and other specialist advisory groups

In response to the global financial crisis we established a Fair Value Expert Advisory Panel to address the fair value measurement of financial instruments when markets become less active. We also observed the meetings of the FASB's Valuation Resource Group, which discussed the implementation of SFAS 157 in the US.

Exposure draft

We published the exposure draft *Fair Value Measurement* in May 2009 with a four-month comment period. All Board members approved its publication.

The staff presented a summary of the 160 comment letters received at the October 2009 Board meeting. Between December 2009 and April 2010 we discussed the comments received in further detail.

The staff consulted the IFRS Advisory Council in November 2007 and November 2009. The fair value measurement project was also discussed in the Council's sessions on the global financial crisis in November 2008, February 2009 and June 2009.

Public hearings

We held public round-table meetings to solicit feedback on the proposals in the May 2009 exposure draft. The round-table meetings were held in November and December 2009 in London, Norwalk and Tokyo. In addition, non-public roundtable meetings were held in Singapore and Kuala Lumpur at the same time.

Field tests

We decided not to undertake field tests for the fair value measurement project because the project would not result in fundamental changes to the fair value measurement guidance already in IFRSs.

Re-exposure

In April 2010 we considered the changes made from the May 2009 exposure draft and decided on the basis of the re-exposure criteria in our Due Process Handbook to expose a proposed new disclosure that was not in the May 2009 exposure draft and was not already required by IFRSs.

That newly proposed disclosure of a measurement uncertainty analysis (ie a range of exit prices that could have been reasonable at the measurement date) was published for public comment in June 2010 with a three-month comment period. All Board members approved its publication. We received 92 comment letters.

In response to the feedback received on the exposure draft, we decided that we would need to perform additional analysis before requiring a quantitative measurement uncertainty analysis disclosure. We complete that analysis when it might result in amendments to the disclosure requirements of IFRS 13.

IFRS 13

We issued IFRS 13 in May 2011, accompanied by a Basis for Conclusions. All Board members approved the IFRS for issue.

Feedback statement

With the FASB we undertook extensive outreach activities. Those outreach activities, combined with the matters raised in the comment letters on the exposure draft, provided important information for developing IFRS 13. As a result, some of the requirements in IFRS 13 are different from those proposed in the exposure draft.

The most prevalent comment received was that we should work with the FASB to resolve any differences between the proposals in our exposure draft and the requirements in US GAAP (Topic 820 *Fair Value Measurements and Disclosures* in the *FASB Accounting Standards Codification*[®]). Topic 820 codified FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157).

As a result, in October 2009 both boards agreed to work jointly to achieve common requirements in IFRSs and US GAAP. Consequently, the FASB agreed to make amendments to Topic 820 as necessary (in June 2010 the FASB published a proposed Accounting Standards Update (ASU) of those amendments).

Other comments indicated that many viewed the proposals in the exposure draft, particularly the revised definition of fair value, as a change to current practice even though we believed that the most significant change would be to move the fair value measurement guidance from individual IFRSs to a single IFRS. Although IFRS 13 describes some of the fair value measurement and disclosure requirements in a different way, there are very few changes to those requirements. Instead, IFRS 13 clarifies the measurement objective and harmonises the disclosure requirements, both of which we think will improve consistency in application.

In the pages that follow we outline the more significant matters raised and how we responded:

- Defining fair value as an exit price
- Principal and most advantageous markets
- Measuring the fair value of a liability
- Measuring the fair value of financial instruments within a portfolio
- Premiums and discounts
- Measuring fair value when markets become inactive
- Disclosures about fair value measurements

Defining fair value as an exit price

The exposure draft proposed defining 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 (an exit price). That was the definition of fair value in US GAAP.

Respondents' comments

Many respondents thought the proposal to define fair value as a market-based current exit price was appropriate because it would retain the notion of an exchange between unrelated, knowledgeable and willing parties in the current definition of fair value in IFRSs, and it would provide a clearer measurement objective. Other respondents thought an entry price would be more appropriate in some situations (eg at initial recognition).

Some respondents were concerned that an exit price definition of fair value and the proposed measurement guidance for applying that definition were more relevant for financial instruments than for non-financial assets and liabilities.

Our response

Our starting point for defining fair value was to use the current exit price definition in US GAAP. However, we needed to ensure that such a definition would be appropriate where fair value was used in a particular IFRS. In our efforts to define fair value with a clear measurement objective we undertook a standard-by-standard review of all IFRSs that required or permitted fair value measurements. We asked interested parties to provide input on that review given their experience in applying the fair value measurement guidance for all types of assets and liabilities, including financial instruments and non-financial assets and liabilities. That input helped us determine the scope of IFRS 13.

Because some respondents to the exposure draft had conceptual objections to using an exit price definition of fair value at initial recognition, we initially considered splitting fair value into two measurements (a current exit price and a current entry price) depending on the circumstances.

Concerns about distinguishing between an entry price and an exit price often relate to potential differences between an actual acquisition price (eg the price paid by an entity to buy an asset, which is an entry price) and a hypothetical sales price (eg the price that would be received to sell that asset, which is an exit price). IFRS 13 describes situations that might lead to differences between entry and exit prices, and other IFRSs determine how to report those differences.

In determining how to define fair value, we considered not only the conceptual differences between entry and exit prices, but also the practical differences between them. Thus, we considered whether there would actually be a difference in the amounts recognised in the financial statements. The work we did in the project to revise IFRS 3 *Business Combinations* in 2008 was helpful in that analysis.

We concluded that even if there are conceptual differences between an entry price and an exit price, in most cases the resulting measurement under both objectives would be the same. Consequently, it did not seem necessary to have two current market-based definitions of value with different focuses (ie one on the entry side of the transaction and one on the exit side of the transaction), so we decided to define fair value as an exit price. An exit price definition of fair value also has the benefit of removing entity-specific factors that might exist in an entry price.

Furthermore, we concluded that some aspects of the measurement guidance were applicable only to particular types of assets or liabilities. For example, a principal market notion applies to any item, whether it is an asset or a liability, and whether it is of a financial or non-financial nature. In contrast, the highest and best use notion applies to non-financial assets and is not relevant for financial assets or for liabilities. IFRS 13 addresses this by distinguishing between types of assets or liabilities when necessary.

Ultimately, the standard-by-standard review resulted in a decision to exclude from the scope of IFRS 13 share-based payment transactions within the scope of IFRS 2 *Share-based Payment* and leasing transactions within the scope of IAS 17 *Leases*. Furthermore, given that the focus of the fair value measurement project was to clarify the measurement objective, we decided to define fair value as an exit price and emphasise that fair value:

- is a market-based measurement, not an entity-specific measurement; and
- takes into account the market conditions at the measurement date.

The definition of fair value in IFRS 13 is the same as in US GAAP.

Principal and most advantageous markets

The exposure draft proposed that fair value should be measured on the basis of a transaction to sell an asset or transfer a liability that takes place in the most advantageous market to which the entity has access. The exposure draft presumed that the market in which the entity normally enters into transactions is the most advantageous market and that an entity may assume that the principal market for the asset or a liability is the most advantageous market.

That was different from the approach in US GAAP, which referred to the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.

Respondents' comments

Many respondents agreed with the most advantageous market notion because most entities enter into transactions that maximise the price they receive for an asset or minimise the price they pay to discharge a liability. Furthermore, a most advantageous market notion works regardless of the level of activity in a market or whether the market for an asset or liability is observable.

However, some respondents thought it might be difficult to identify and select the most advantageous market when an asset or liability is exchanged in multiple markets. Others were unsure whether the most advantageous market had to be used or how the market in which the entity normally enters into transactions relates to the principal or most advantageous market. In general, respondents preferred the approach in US GAAP.

Our response

Although we think that in most cases the principal market and the most advantageous market would be the same, we agreed that the focus should be on the principal market for the asset or liability. The principal market is the market with the greatest volume and level of activity for the asset or liability. We concluded that the principal market would provide the most representative input for a fair value measurement because that market is the most liquid market for the asset or liability.

Given the feedback received and the need to develop common fair value measurement guidance in IFRSs and US GAAP, we decided to specify that a fair value measurement assumes that the transaction to sell an asset or to transfer a liability takes place in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.

There is a presumption in IFRS 13 that the principal market is the market in which an entity normally enters into transactions for the asset or liability unless there is evidence that another market has a greater volume and level of activity.

Measuring the fair value of a liability

The exposure draft proposed the following with respect to liabilities:

- An entity can estimate a transfer price for a liability using the fair value of the corresponding asset or the amount that would be incurred in fulfilling the obligation.
- The fair value of a liability reflects the risk that an entity will not fulfil an obligation (non-performance risk).
- The fair value of a liability should not be adjusted for the effect of a restriction on its transfer if that restriction is already included in the other inputs to the fair value measurement.

That is consistent with the approach in US GAAP (Topic 820 was amended in August 2009 to provide additional guidance about measuring the fair value of liabilities).

Respondents' comments

The views on the proposals to define the fair value of a liability as a transfer price and to include the effect of non-performance risk were mixed. Many respondents thought that fair value, when defined as a transfer price for liabilities, would not be an appropriate measurement basis for most liabilities and would only be appropriate for those liabilities that can and are intended to be transferred.

Although many did not agree with a transfer notion for liabilities, respondents generally found the guidance about using the fair value of the corresponding asset or a fulfilment amount to measure the fair value of a liability helpful, particularly because that is typically how they think about the value of a liability. Many of the participants at our round-table meetings in the US said they had found the additional guidance in US GAAP useful.

In addition, although few respondents questioned the usefulness of reflecting non-performance risk in the fair value measurement of a liability at initial recognition, many questioned the usefulness of doing so after initial recognition. In particular, they believed that including the effects of changes in an entity's own credit risk or changes in the price of credit in the fair value of a liability and recognising those changes in profit or loss leads to counter-intuitive and potentially confusing reporting (ie gains for credit deterioration and losses for credit improvements).

Our response

Because the measurement guidance for liabilities in US GAAP was consistent with the proposals in the exposure draft, we worked with the FASB to develop a combination of the two.

As a result, IFRS 13 states that in the absence of a quoted price in an active market to transfer the identical liability, an entity would measure the fair value of the liability as follows:

- using the quoted price in an active market for the identical liability held by another party as an asset, if that price is available.
- if that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical liability held by another party as an asset.
- if neither of those observable prices is available, using another valuation technique (eg using market comparable data or discounted cash flows).

With respect to non-performance risk, IFRS 13 carries forward the proposal in the exposure draft and states that the fair value of a liability reflects the effect of non-performance risk. Concerns about reporting changes in an entity's own credit risk in the statement of comprehensive income were addressed in developing IFRS 9 *Financial Instruments*, issued in 2010.

IFRS 13 also states that the fair value of a liability should not be adjusted further for the effect of a restriction on its transfer if that restriction is already included in the other inputs to the fair value measurement.

The guidance for measuring the fair value of an entity's own equity instruments is consistent with that for measuring liabilities.

Measuring the fair value of financial instruments within a portfolio

A topic that was of particular interest for financial institutions was the measurement of financial instruments managed within a portfolio.

The exposure draft proposed that the fair value measurement of a financial asset assumes that its fair value would be maximised by using the asset on a stand-alone basis (referred to in the exposure draft as the in-exchange valuation premise) because the market-based view of fair value assumes that there is no incremental value from holding a financial asset within a portfolio. The exposure draft also proposed an amendment to IAS 39 *Financial Instruments: Recognition and Measurement*, specifying that the unit of account for a financial instrument is the individual financial instrument at all levels of the fair value hierarchy (ie Levels 1, 2 and 3).

US GAAP did not specify the valuation premise for financial assets.

Respondents' comments

The proposal to require the fair value of a financial asset to be measured using the in-exchange valuation premise was generally not supported. Some respondents believed that when combined with the proposed amendment to IAS 39 about the unit of account for financial instruments, the fair value of financial assets does not reflect that those assets are held within a portfolio, even when an entity manages its financial instruments on the basis of the entity's net exposure, rather than its gross exposure, to market risks and credit risk. Those proposals were viewed as a major change in the practice of measuring the fair value of financial instruments.

Respondents were concerned that the exposure draft proposed a separation in the valuation of financial instruments for financial reporting from the entity's internal risk management practices. In addition, those respondents were concerned about the systems changes that would be necessary to effect the change.

To preserve the relationship between financial reporting and risk management, some respondents asked whether they would be able to apply the proposed bid-ask spread guidance to each of the individual instruments so that the sum of the fair values of the individual instruments equals the value of the net position.

Other respondents suggested that we should continue to allow the existing practice under IAS 39 and IFRS 9, which stated:

When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate.

As with other aspects of the proposals in the exposure draft, respondents asked us to work with the FASB to ensure that IFRSs and US GAAP have the same requirements for measuring the fair value of financial instruments.

Our response

Because fair value is a market-based measurement, the fair value of a financial asset reflects any benefits that market participants would derive from holding that asset within a diversified portfolio. Therefore, an entity would derive no incremental value from holding the asset within a portfolio. IFRSs and US GAAP did not explicitly address how the current measurement requirements for financial instruments managed within a portfolio meet the objective of a fair value measurement. For example, entities typically do not manage their exposure to market risks and credit risk by selling a financial asset or transferring a financial liability (eg by unwinding a transaction). Rather, they manage their risk exposure by entering into a transaction for another financial instrument (or instruments) that would result in an offsetting position in the same risk.

In addition, an entity's net risk exposure is a function of the other financial instruments held by the entity and of the entity's risk preferences (both of which are entity-specific decisions and, thus, do not form part of a fair value measurement).

As a result, we decided to permit an exception to the requirements for measuring fair value that allows an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (ie an asset) for a particular risk exposure or to transfer a net short position (ie a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date. That exception applies to financial instruments measured at fair value on a recurring basis in the statement of financial position.

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.

Premiums and discounts

The exposure draft did not address premiums and discounts in measuring fair value. However, it proposed amending IAS 39 to specify that at all levels of the fair value hierarchy the unit of account for a financial instrument is the individual financial instrument. The effect of that proposal would be the prohibition of a premium or a discount related to the size of an entity's holding of financial instruments.

Respondents' comments

Most respondents did not support the proposal. In their view, entities do not typically exit a position on an individual instrument basis (eg by entering into a transaction to sell a single ordinary share). Furthermore, they think a fair value measurement should reflect the fair value of the entity's holding, not of an individual instrument within that holding. As a result, those respondents thought that the prohibition of a blockage factor, which is the term used in US GAAP to describe an adjustment related to the size of an entity's holding relative to the trading volume of the underlying assets or liabilities making up that holding, would not reflect the economic position of an entity with such a holding. The FASB received similar comments when developing SFAS 157.

In addition, respondents had different interpretations about what the term *blockage factor* means. Some respondents thought we intended to prohibit any premium or discount (such as a control premium or a discount for lack of marketability) even when market participants would take into account that premium or discount when pricing the asset or liability at a particular unit of account level.

Our response

We concluded that it was necessary:

- to clarify that a fair value measurement incorporates premiums or discounts when they reflect a characteristic of the asset or liability that market participants would take into account in a transaction for the asset or liability.
- to prohibit the application of a blockage factor (which IFRS 13 describes as an adjustment to the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity). In our view, that prohibition is appropriate because it is a discount that reflects size as a characteristic of the entity's holding rather than as a characteristic of the asset or liability being measured at fair value.

Measuring fair value when markets become inactive

The global financial crisis highlighted the need for our fair value measurement guidance to address specifically how to measure fair value when the activity in the market for an asset or liability declines (ie when markets become inactive).

Respondents' comments

Most respondents supported the proposals in the exposure draft because they found the Fair Value Expert Advisory Panel's report and the FASB's FSP helpful when measuring fair value in the global financial crisis, and the exposure draft reflected that guidance. For example, they welcomed the proposal to use a valuation technique when there are no observable market prices available or when observable market prices do not represent the fair value of the asset or liability held by the entity.

However, many respondents urged us to work with the FASB to agree on identical wording to ensure that the requirements in IFRSs and US GAAP would be interpreted in the same way. In addition, some respondents thought that the exposure draft did not adequately reflect some of the discussions of the Panel and suggested that additional aspects of the report should be included in the IFRS on fair value measurement.

Furthermore, prudential regulators requested that we address measurement uncertainty to ensure that fair value measurements, in particular those categorised within Level 3 of the fair value hierarchy, are not overstated or understated in the statement of financial position.

Our response

In response to those concerns, we agreed with the FASB to align the wording in our fair value measurement standards, which involved amendments to US GAAP.

IFRS 13 acknowledges that when market activity declines, an entity must use a valuation technique to measure fair value. IFRS 13 provides detailed guidance for the following situations:

- when there is observable market activity for an asset or a liability;
- when there is a decline in observable market activity for an asset or a liability; and
- when there is typically no observable market activity for an asset or a liability.

IFRS 13 emphasises that the focus when measuring fair value when markets have become inactive is on whether an observed transaction price is the result of an orderly transaction (as opposed to a forced liquidation or distress sale), not necessarily on the level of activity in a market. Even in a market with little activity, orderly transactions can take place.

IFRS 13 specifically addresses measurement uncertainty. It describes the valuation adjustments that an entity might need to make when a valuation technique or the inputs to a valuation technique used to measure fair value do not capture factors that market participants would take into account when pricing the asset or liability, including assumptions about risk. In other words, any adjustment must be consistent with the objective of a fair value measurement, ensuring that the fair value measurement is not overstated or understated. Adjustments for measurement uncertainty apply in any economic environment.

The principles in IFRS 13 apply to the fair value measurement of any asset or liability, whether financial or non-financial, when the market activity for the item declines.

Disclosures about fair value measurements

Because the fair value measurement project focused on how to measure fair value, it was necessary to find an appropriate way for entities to provide information about how they arrived at those measurements and to explain changes from period to period, particularly for fair value measurements categorised within Level 3 of the fair value hierarchy.

The proposals in the exposure draft used IFRS 7 and SFAS 157 as a starting point, and were expanded because of the feedback received from users of financial statements with suggestions on improving the fair value measurement disclosures. We also received input from our Fair Value Expert Advisory Panel.

Respondents' comments

Respondents generally supported the proposed disclosures because they further aligned the requirements in IFRSs and US GAAP. However, some expressed concern that the exposure draft and US GAAP used different words, even when referring to the same requirements. For example, US GAAP distinguished between recurring and non-recurring fair value measurements and to realised and unrealised gains or losses, whereas our exposure draft did not. Some respondents expressed concern that some might interpret them as requiring different information and suggested that we work with the FASB to align both the requirements and the wording.

In addition, there was strong support for more information being disclosed about fair value measurements categorised within Level 3 of the fair value hierarchy because of the inherent subjectivity of those measurements. Those comments led us to re-expose our proposal to require a sensitivity analysis of fair value measurements categorised within Level 3 of the fair value hierarchy to require instead a measurement uncertainty analysis disclosure (which provides a range of exit prices that could have been reasonable at the measurement date).

Few preparers and auditors of financial statements supported that proposal, stating that it would not provide useful information and would be costly and operationally challenging. Although the proposal was in response to requests from users of financial statements (who did not provide formal comments to the proposal) to require additional information about the measurement uncertainty inherent in fair value measurements, the responses from preparers of financial statements indicated that the costs associated with preparing such a disclosure would outweigh the benefits to users once the information had been aggregated by class of asset or liability.

As an alternative to the proposal, some respondents suggested that we should require a qualitative assessment of the subjectivity of fair value measurements categorised with Level 3 of the fair value hierarchy, as well as an alternative quantitative approach that would be less costly to prepare.

Our response

As with the measurement guidance, we worked with the FASB to align the wording of the disclosure requirements in IFRSs and US GAAP.

Some of the disclosures in IFRS 13 were already required elsewhere in IFRSs. For example, the fair value disclosures in IFRS 7 (some of which were added in March 2009 in response to the global financial crisis) were relocated to IFRS 13. In addition, many IFRSs already required disclosure of the valuation techniques and inputs used in a fair value measurement and reconciliations of opening balances to closing balances (although on a broader level than the Level 3 reconciliation).

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

- reconciliation from opening to closing balances (which was proposed in the exposure draft and was required by IFRS 7 for financial instruments);
- quantitative information about the significant inputs used in the valuation technique(s) (which was proposed in the exposure draft);
- valuation processes used by the entity (which was not proposed in the exposure draft, but was described in the Fair Value Expert Advisory Panel's report); and
- sensitivity to changes in significant unobservable inputs (a narrative discussion for all fair value measurements and a quantitative analysis for financial instruments—A quantitative analysis was proposed in the exposure draft for all assets and liabilities measured at fair value).

We and the FASB will continue to assess whether a quantitative measurement uncertainty analysis disclosure would be practical, with the aim of reaching a conclusion about whether to require such a disclosure.

Cost-benefit considerations

We performed a qualitative assessment of the costs and benefits associated with the introduction of IFRS 13.

IFRS 13 introduces a clear definition of fair value, along with a framework for measuring fair value that will eliminate inconsistencies across IFRSs that have contributed to diversity in practice. The result should be enhanced comparability of information reported in financial statements.

The disclosures about fair value measurements are expected to increase transparency and improve the quality of information provided to users of financial statements. In developing the disclosure requirements, we obtained input from users and preparers of financial statements and other interested parties to assess whether the disclosures could be provided within reasonable cost-benefit constraints.

Although the framework for measuring fair value builds on current practice and requirements, some aspects of IFRS 13 may result in a change to practice for some entities.

Furthermore, some entities will incur incremental costs because they will need to make systems and operational changes. For example, entities will need to develop processes for:

- categorising fair value measurements within the fair value hierarchy;
- assessing market participant assumptions;
- determining the principal (or most advantageous) market for an asset or a liability; and
- determining the point within the bid-ask spread that is most representative of fair value in the circumstances.

Entities will also need:

- to determine the most appropriate way for them to present the inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy; and
- to develop descriptions of their valuation processes and the sensitivity of the valuation to changes in unobservable inputs.

The benefits resulting from increased consistency in the application of fair value measurement requirements and enhanced comparability of fair value information and improved communication of that information to users of financial statements will be ongoing. Our assessment is that the improvements in financial reporting resulting from the application of IFRS 13 will exceed the increased costs of applying it.

Important information

This Project Summary and Feedback Statement has been compiled by the staff of the IFRS Foundation for the convenience of interested parties. The views expressed within this document are those of the staff who prepared the document. They do not purport to represent the views of the IASB and should not be considered as authoritative.

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