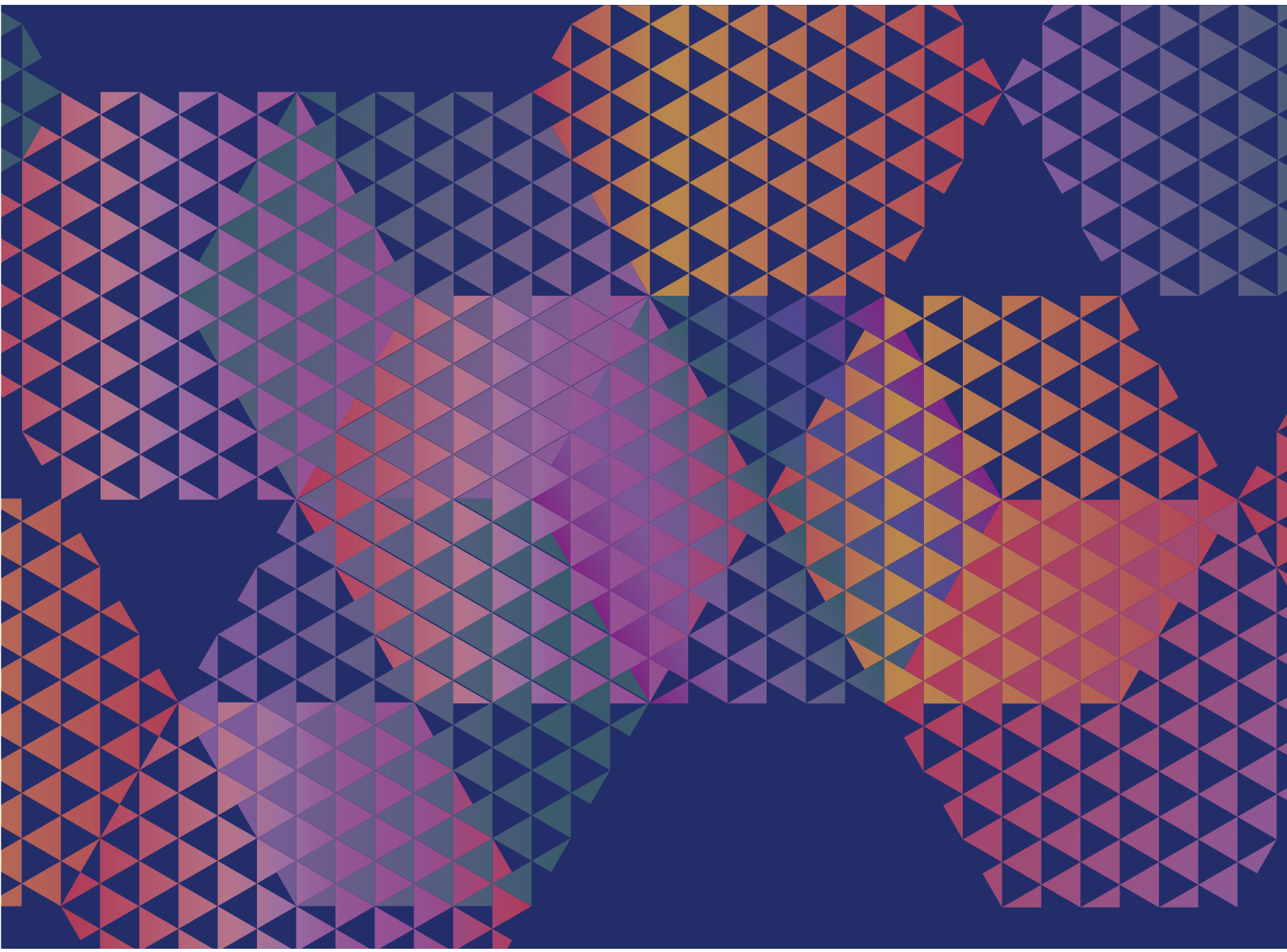
IFRS® Accounting

Educational Module 12
Fair Value Measurement

IFRS for SMEs®

Accounting Standard

Third Edition



International Accounting Standards Board

IFRS® Foundation
Supporting Material for the
IFRS for SMEs® Accounting Standard

including the full text of
Section 12 *Fair Value Measurement*
of the *IFRS for SMEs* Accounting Standard issued by
the International Accounting Standards Board in February 2025

with extensive explanations, self-assessment questions and case studies

Contents

The requirements of Section 12 *Fair Value Measurement* of the *IFRS for SMEs* Accounting Standard are set out in this module and shown with grey shading. Appendix B of the *IFRS for SMEs* Accounting Standard contains the glossary (Glossary) and is part of the requirements. Terms defined in the Glossary are reproduced in **bold** type the first time they appear in the text of Section 12.

This module has been prepared by the International Accounting Standards Board (IASB) technical staff. The educational notes and examples inserted by the staff are not shaded. These educational notes and examples do not form part of the *IFRS for SMEs* Accounting Standard and have not been approved by the IASB.

INTRODUCTION

IFRS for SMEs® Accounting Standard

The *IFRS for SMEs* Accounting Standard (Standard) is intended for use by small and medium-sized entities that publish general purpose financial statements and that do not have public accountability (referred to as small and medium-sized entities—see Section 1 *Small and Medium-sized Entities* of the Standard).

The objective of general purpose financial statements is to provide information about a reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

More information about the Standard and its supporting materials is available on the IFRS Foundation website: www.ifrs.org.

This module

This educational module supports the requirements for measuring fair value and providing disclosures about fair value measurements in accordance with Section 12 *Fair Value Measurement* of the Standard.

The module:

- provides explanations and examples to improve understanding of the Section 12 requirements;
- identifies the significant judgements required to measure fair value and make disclosures about fair value measurements;
- includes questions to test your understanding of the Section 12 requirements; and
- includes case studies that provide a practical opportunity to apply the Section 12 requirements.

The module focuses on fair value measurements that are likely to be encountered by SMEs.

The *IFRS for SMEs* Accounting Standard permits or requires an SME to measure some assets and liabilities at fair value. An SME might use a third-party valuation specialist to help determine fair value measurements. If the SME appoints a third-party valuation specialist, it will still need to ensure that the valuation is made in accordance with the requirements in Section 12.

SMEs using the Standard and users reading their financial statements do not need any knowledge of IFRS Accounting Standards. Section 12 uses the definitions and measurement principles of IFRS 13 *Fair Value Measurement*. The section uses simplified language and covers the topics that are most relevant to SMEs, as well as illustrative examples likely to reflect the experiences of SMEs.

One area of complexity that SMEs might encounter is measuring the fair value of unquoted equity instruments, for example, a non-controlling interest in another entity (the investee). In December 2012, the IASB issued educational material on fair value measurement to accompany IFRS 13.[1] Examples and guidance from the material supporting IFRS 13 have been included in this module, adapted for SMEs.

After completing the module, you should be able to:

- define fair value and explain the objective of fair value measurement;
- identify when another section requires or permits fair value measurements or disclosures about fair value measurements in accordance with Section 12;
- determine which characteristics of assets and liabilities are to be considered when determining their fair value;
- identify both the principal market and the most advantageous market for an asset;
- explain how to determine the highest and best use for non-financial assets when measuring their fair value;
- describe three widely used valuation approaches used to make fair value measurements;
- identify appropriate valuation techniques for valuing different assets applying Section 12;
- categorise inputs to valuation techniques into three levels—Level 1, Level 2 and Level 3—applying the fair value hierarchy in Section 12;
- prepare disclosures about fair value measurements that could satisfy the disclosure requirements in Section 12; and
- demonstrate an understanding of some of the significant judgements that are required in measuring fair value and disclosing fair value measurements.

Which version of the Standard does the module refer to?

Any reference in this module to 'the *IFRS for SMEs* Accounting Standard' is to the third edition of the Standard, issued February 2025.

1 https://www.ifrs.org/content/dam/ifrs/supporting-implementation/ifrs-13/education-ifrs-13-eng.pdf.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity that is useful to existing and potential investors, lenders and other creditors when making decisions relating to providing resources to the entity.

Section 12 sets out the requirements for measuring fair value and disclosing information about fair value measurements. It applies to all parts of the Standard that require an SME to measure an asset or liability at fair value, except for parts that are specifically excluded.

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date under current market conditions.

An SME is required to follow a series of steps when making a fair value measurement:

- **Step 1**—Identify the particular asset or liability that is the subject of the fair value measurement as required by other sections of the Standard (see paragraphs 12.1–12.2).
- **Step 2**—Determine the principal (or most advantageous) market for the asset or liability (see paragraphs 12.6–12.9). A market cannot be identified as the principal (or most advantageous) market unless the entity has access to that market at the measurement date.
- **Step 3**—For a non-financial asset, determine whether its highest and best use is through stand-alone use or in combination with other assets (see paragraphs 12.10–12.13). An entity assumes the current use of a non-financial asset is its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset. This principle is not relevant for financial assets.
- **Step 4**—Determine the valuation technique(s) appropriate for the fair value measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability (see paragraphs 12.14–12.15).

If a reliable measure of fair value is no longer available for an asset that was previously measured at fair value, an SME shall instead use the asset's carrying amount[2] at the last date the asset was reliably measurable at fair value as its new cost (see paragraphs 12.18–12.21). This method also applies when an undue cost or effort exemption from measuring an asset or liability at fair value becomes available.

Section 12 prescribes a fair value hierarchy that categorises the inputs to valuation techniques used to measure fair value into three levels (see paragraphs 12.22–12.27). An entity is required to categorise the fair value measurement into one of the three levels in the fair value hierarchy (based on the lowest level input that is significant to the entire measurement) and prepare the accompanying disclosures required by Section 12 (see paragraphs 12.28–12.32).

2 The carrying amount of an asset is the amount at which an asset is recognised in the statement of financial position.

What has changed in the third edition of the Standard?

Section 12 is a new section introduced in the third edition of the Standard that includes the requirements for measuring fair value and the related disclosure requirements that apply to almost all assets and liabilities that the Standard requires to be measured at fair value (see the section in this module on the scope of Section 12).

In the second edition of the Standard, the requirements for measuring fair value were included in the section on basic financial instruments (Section 11). Other sections of the Standard that required or permitted the use of fair value either referred to that section or included specific fair value measurement requirements for the assets and liabilities. The disclosure requirements for fair value measurements were also distributed across several sections of the second edition of the Standard.

When the IASB introduced Section 12, it decided to consolidate the requirements for measuring fair value (and related disclosure requirements) into this single new section. Section 12 reduces complexity and improves consistency in the application of fair value measurement principles by establishing a single set of requirements (a single framework) in Section 12 that applies to all fair value measurements, unless specifically exempted.

Furthermore, Section 12:

- clarifies the definition of fair value, making it easier to apply than the definition in the second edition; and
- improves transparency by requiring more explicit disclosures about fair value measurements.

Section 12 applies when other sections require or permit fair value measurements. It does not introduce new requirements to measure an asset or a liability at fair value, change what is measured at fair value in the Standard or prescribe detail on presentation of changes in fair value.

Transition requirements are explained on page 49.

REQUIREMENTS AND EXAMPLES

Scope of this section

12.1 This section applies when another section requires or permits **fair value** measurements or disclosures about fair value measurements, except:

(a) **share-based payment transactions** within the scope of Section 26 *Share-based Payment*; and

(b) leasing transactions within the scope of Section 20 *Leases*.

12.2 The disclosures required by this section are not required for:

(a) **plan assets** measured at fair value in accordance with Section 28 *Employee Benefits*; and

(b) **assets** for which the **recoverable amount** is fair value less costs of disposal in accordance with Section 27 *Impairment of Assets*.

Educational notes

Section 12 does not specify when an entity is required or permitted to use fair value. Instead, Section 12 provides requirements for how to measure the fair value of assets and liabilities when fair value measurement is required or permitted by other sections of the Standard. For example, Section 11 *Financial Instruments* specifies when financial instruments are required or permitted to be measured and/or disclosed at fair value.

An entity applying Section 12 first needs to identify the asset or liability that is the subject of the fair value measurement requirements or related disclosures. This identification depends on the requirements in other sections of the Standard.

The item being measured might be:

- a single asset or liability, for example, an investment property in the scope of Section 16 *Investment Property*; or
- a group of assets or a group of assets and liabilities, for example, a cash-generating unit in Section 27 *Impairment of Assets*. When determining the recoverable amount applying Section 27, an entity might be required to measure the fair value less costs of disposal of a cash-generating unit.

Examples of assets or liabilities for which other sections of the Standard require or permit fair value measurements and therefore Section 12 applies include:

- a retained interest in a former subsidiary that is measured at fair value when control is lost (Section 9 *Consolidated and Separate Financial Statements*);
- investments in non-convertible preference shares and non-puttable ordinary or preference shares that are measured at fair value if fair value can be measured reliably without undue cost or effort (Part I of Section 11 *Financial Instruments*);
- investment property that is measured after initial recognition at fair value if fair value can be measured reliably without undue cost or effort (Section 16);
- items of property, plant and equipment that are measured after initial recognition at a revalued amount, where the revalued amount is the fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses (Section 17 *Property, Plant and Equipment*);
- identifiable assets and liabilities of an acquiree measured at fair value at the acquisition date (Section 19 *Business Combinations and Goodwill*);
- the recoverable amount of an asset or a cash-generating unit determined under Section 27 if such an amount is based on fair value less costs of disposal;
- biological assets measured at fair value less costs to sell at initial recognition and subsequently under Section 34 *Specialised Activities*;
- agricultural produce measured at fair value less estimated costs to sell at the point of harvest under Section 34;
- financial assets and financial liabilities measured at fair value in the scope of Part II of Section 11; and
- an entire compound financial instrument and the liability component of that compound financial instrument—for the purpose of measuring the debt and equity components of the instrument at initial recognition under Section 22 *Liabilities and Equity*.

This list of examples is not exhaustive. Section 12 applies whenever the Standard refers to a fair value measurement or disclosures about fair value measurement, unless specifically exempted in paragraphs 12.1 or 12.2.

Section 12 contains two types of scope exclusions:

- items that are outside the scope of both the measurement and disclosure requirements in Section 12 (see paragraph 12.1); and
- items that are inside the scope of the measurement requirements in Section 12 but for disclosure requirements are inside the scope of another section.

Some measurements based on current values in other sections of the Standard are not fair value measurements and are not in the scope of Section 12. Examples include ‘value in use’ in Section 27 and ‘selling price less costs to complete’ in Section 2 *Inventories*.

Examples—Scope of Section 12

Ex 1 An SME owns a building in the city.

The SME might need to apply Section 12 to determine the fair value of its building in any of the following circumstances:

- the building meets the definition of an investment property in the scope of Section 16 *Investment Property*. Section 16 requires investment property to be measured after initial recognition at fair value if fair value can be measured reliably without undue cost or effort.
- the building is in the scope of Section 17 *Property, Plant and Equipment* and the SME uses the revaluation model in Section 17 to measure its buildings (see also Example 2).
- the SME is required to measure fair value less costs to sell of the building in order to determine the recoverable amount of the building for an impairment test in accordance with Section 27 *Impairment of Assets*. Note that, applying paragraph 27.12 of the Standard, it is not always necessary to determine both the building's fair value less costs to sell and its value in use when measuring the recoverable amount. For example, if the building's value in use exceeds its carrying amount, the building is not impaired and it is not necessary to estimate its fair value less costs to sell.
- the SME acquired the building in a business combination applying Section 19 *Business Combinations and Goodwill*. The building is an identifiable asset that is measured at fair value at the acquisition date.
- the SME distributes the building to its owner-manager. SMEs are required to measure non-cash distributions at fair value when the fair value can be measured reliably without undue cost or effort applying Section 22 *Liabilities and Equity*.

Ex 2 An SME owns a guest house and the surrounding area of land. The SME uses the revaluation model in Section 17 *Property, Plant and Equipment* to measure its land and buildings.

Applying the revaluation model in Section 17, the SME is required to measure an item of property, plant and equipment whose fair value can be measured reliably at a revalued amount that is its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from the amount which would be determined using fair value at the end of the reporting period.

The fair value of the land and the fair value of the building are measured applying Section 12, considering their highest and best use (see paragraphs 12.10–12.11 of this section for further guidance). The disclosure requirements in Section 12 also apply.

Note that paragraph 17.8 of the Standard states that land and buildings are separable assets and an entity shall account for them separately.

Ex 3 **At its year-end, an SME grants 100 share options to an employee conditional upon the employee remaining in the entity's employment for two years.**

The share options are share-based payments in the scope of Section 26 *Share-based Payment*. Although the SME applies Section 26 to measure the fair value of the services received by reference to the fair value of the equity instruments granted, this fair value measurement is outside the scope of Section 12. The disclosure requirements in Section 12 do not apply to share-based payments in the scope of Section 26.

Paragraph 26.1D of the Standard states that 'This section [Section 26] uses the term "fair value" in a way that differs in some respects from the definition in the Glossary and in other sections of this Standard. When applying this section, an entity shall apply the definition of fair value in paragraph 26.1E and measure fair value in accordance with this section, not Section 12 *Fair Value Measurement*.'

Ex 4 **At its year-end, an SME has a provision for a legal claim applying Section 21 *Provisions and Contingencies*.**

A provision in the scope of Section 21 is not measured at fair value. The provision for the legal claim is measured, applying Section 21, at the best estimate of the amount to settle the obligation. The requirements in Section 12 do not apply to measuring and disclosing the provision for the legal claim.

Ex 5 **At its year-end, an SME has a defined benefit plan for its employees.**

Section 28 *Employee Benefits* requires the SME to measure a defined benefit liability for its obligation under the defined benefit plan at the reporting date at the net total of:

- the present value of its obligation under the defined benefit plan at the reporting date; and
- the fair value at the reporting date of plan assets (if any) out of which the obligation is to be settled directly.

The plan assets are measured at fair value applying the measurement requirements in Section 12. However, the disclosure requirements in Section 12 do not apply to the plan assets (see paragraph 12.2).

An entity's obligations under defined benefit plans are not measured at fair value and so the entity should apply the measurement and disclosure requirements in Section 28.

Measurement

Objective of fair value measurement

12.3 The objective of a fair value measurement is to estimate the price at which an **orderly transaction** (not a forced transaction) to sell an asset or to transfer a **liability** would take place between **market participants** at the measurement date under current market conditions (an exit price at the measurement date).

Measurement principles

12.4 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. Fair value is a market-based rather than entity-specific measurement. An entity shall measure fair value using the same assumptions that market participants would use when pricing the asset or liability. The entity's intention to hold the asset or settle the liability is not relevant.

Definitions

The following definitions are reproduced from the Glossary:

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.

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).

Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

(a) they are independent of each other, that is, they are not related parties as defined in Section 33;

(b) they are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information;

(c) they are able to enter into a transaction for the asset or liability; and

(d) they are willing to enter into a transaction for the asset or liability—that is, they are motivated but not forced or otherwise compelled to do so.

Educational notes

Objective of fair value measurement

Paragraph 12.3 sets out the objective of fair value measurement. That objective applies regardless of the reason for the fair value measurement.

Some assets and liabilities that are measured at fair value are unlikely to be sold or transferred by an entity. For example, some intangible assets acquired in a business combination, such as trade marks and customer-related intangible assets, might be sold only as part of the future sale of part or all of the business. Even when there is no observable market to provide pricing information about the sale of an asset or the transfer of a liability at the measurement date, a fair value measurement assumes that a transaction takes place at that date, considered from the perspective of a market participant that holds the asset or owes the liability. Such an 'assumed' transaction establishes a basis for estimating the price to sell the asset or to transfer the liability.

The objective of a fair value measurement is often referred to as determining an exit price because it aims to reflect the price at which a market participant that holds the asset or owes the liability could exit from the asset or liability. For example, when measuring the fair value of a liability applying Section 12, an entity determines the price that would be paid to transfer that liability to a third party, rather than the cost of settling the liability.

Identifying transactions that are not orderly

A fair value measurement assumes an orderly sale or transfer takes place, rather than a forced transaction or distress sale.

Determining whether a transaction is orderly can be more difficult if there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or for a similar asset or liability). A transaction might not be orderly if:

- the seller is in or near bankruptcy or receivership—that is, the seller is distressed.
- the seller was required to sell to meet regulatory or legal requirements—that is, the sale was forced.
- the transaction price is an outlier compared to other recent transactions for the same or a similar asset or liability.
- the asset or liability did not have 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. The customary time depends on the type of asset or liability. For some assets (for example, quoted shares), the usual and customary exposure to the market may be short. For other assets (for example, property), longer market exposure would be required to contact potential buyers, conduct negotiations and any investigation work, and complete legal agreements.
- there was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

An entity shall evaluate the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly.

If the evidence indicates that a transaction is not orderly, an entity shall place little, if any, weight on that transaction price (compared with other indications of fair value).

Example—Orderly transaction

Ex 6 **An SME needs to sell an investment property quickly to raise cash for a loan repayment. Instead of taking its estate agent's advice to market the property for a few weeks, it accepts the first offer even though this offer is lower than the agent's estimate.**

The sale is not an orderly transaction because it was conducted more quickly than would be usual for a property sale and the SME did not have time to adequately market the property.

If the SME prepared financial statements between agreeing on the sale and completing it, the agreed sale price might not be the same as the fair value of the property reported in the financial statements. However, note that the actual sale amount would still be accounted for as the proceeds on sale in the next set of financial statements.

Educational notes

Market-based versus entity-specific measurement

A fair value measurement does not consider management's intentions for the asset or liability at the measurement date. Instead, it represents a market-based measurement that contemplates a hypothetical transaction between market participants at the measurement date.

When measuring fair value, an entity is required to use the assumptions that market participants would use when pricing the asset or liability. However, Section 12 does not require an entity to identify specific market participants. Instead, the definition of market participants requires an entity to consider the characteristics of market participants that would generally transact for the asset or liability being measured.

Example—Market-based versus entity-specific measurements

Ex 7 **An SME owns a building that it leases to a local charity at below market rent. The SME plans to continue to lease the building to the charity.**

When measuring the fair value of its investment property, the SME determines the price that would be received to sell the building in an orderly transaction between market participants at the measurement date. The fact that the SME does not intend to sell the building is not relevant when determining fair value.

The intention is irrelevant because fair value is a market-based rather than an entity-specific measurement. The SME does not measure the value of the building based on how it is being used in the SME's business.

Nevertheless, if the charity has a long-term lease on the building, the lease might be considered a restriction on the use of the asset if market participants would take that characteristic into account when pricing the asset or liability at the measurement date (see paragraph 12.5(b)).

12.5 An entity shall take into account the characteristics of the asset or liability when measuring fair value if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include:

(a) the condition and location of the asset; and

(b) restrictions, if any, on the sale or use of the asset.

Educational notes

In measuring an asset's fair value, an entity might need to make adjustments to an observable market price for the asset in order to reflect the price that market participants would be prepared to pay for the asset in its current condition or location. For example, the entity might need to deduct the cost of transporting the asset to the market if location is a characteristic of the asset being measured (see paragraph 12.8).

A legal or contractual restriction on the sale or use of an asset should be incorporated into the asset's fair value measurement if:

- the restriction is a characteristic of the asset; and
- market participants would consider the effect of the restriction when pricing the asset.

Example—Characteristics of an asset

Ex 8 An SME owns a piece of land that has been used for farming. The land has been contaminated by improper handling of pesticides. The land cannot be legally sold until it has been remediated.

When measuring the fair value of the land, the SME would need to take into account both the condition of the land (the land is contaminated) and the restriction on sale of the land (the land cannot be sold until it has been remediated). These factors may require an adjustment to be made to the fair value measurement.

Examples—Restrictions on the sale of an asset

Ex 9 An SME borrows money from a bank. The SME pledges a property as security for the loan. The SME is restricted from selling the property during the term of the loan.

Although the SME is unable to sell the property during the term of the loan, other market participants would not be subject to the same restriction. The restriction on sale of the property is therefore entity-specific—that is, it is not a characteristic of the property. Therefore, the restriction is not reflected in the fair value measurement of the property.

Ex 10 **A donor contributes land in an otherwise developed residential area to a not-for-profit neighbourhood association which is an SME. The land is currently used as a playground. The donor specifies that the land must continue to be used by the SME as a playground in perpetuity. Upon review of legal and other documentation, the SME determines that the fiduciary responsibility to meet the donor's restriction would not be transferred to market participants if the association sold the asset, that is, the donor restriction on the use of the land is specific to the SME. Furthermore, the SME is not restricted from selling the land. Without the restriction on the use of the land by the SME, the land could be used as a site for residential development. In addition, the land is subject to an easement (that is, a utility has a legal right to run power lines across the land).**

The potential effects on the fair value measurement of the land arising from the restriction and the easement are assessed separately for these two features:

- *donor restriction on use of land*—because in this situation the donor restriction on the use of the land is specific to the SME, the restriction would not be transferred to market participants. Therefore, the fair value of the land would be the higher of its fair value used as a playground and its fair value as a site for residential development, regardless of the restriction on the use of the land by the association.
- *easement for utility lines*—because the easement for utility lines is specific to (that is, a characteristic of) the land, it would be transferred to market participants with the land. Therefore, the fair value measurement of the land would take into account the effect of the easement, regardless of whether the highest and best use (see paragraphs 12.10–12.13) is as a playground or as a site for residential development.

12.6 An entity shall assume that the transaction to sell the asset or transfer the liability takes place in either:

(a) the **principal market** for the asset or liability; or

(b) in the absence of a principal market, the **most advantageous market** for the asset or liability.

12.7 The entity must have access to the principal (or most advantageous) market at the measurement date. In the absence of evidence to the contrary, an entity shall assume the market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability is the principal market or, in the absence of a principal market, the most advantageous market. Even if no observable market exists, the entity shall assume that a transaction takes place at the measurement date as a basis for estimating fair value.

Definitions

The following definitions are reproduced from the Glossary:

The **principal market** is the market with the greatest volume and level of activity for the asset or liability.

The **most advantageous market** is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

Transaction costs are the costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:

(a) they result directly from and are essential to that transaction; and

(b) they would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made.

Note that an entity ignores transaction costs when measuring fair value. However, transaction costs are considered when identifying the most advantageous market for an asset or a liability.

Educational notes

The principal market is the market with the greatest volume or level of activity for the asset or liability, regardless of the volume or level of activity of the entity's transactions in a particular market. Because the principal market is the most liquid market for the asset or liability, that market will provide the most representative input for a fair value measurement.

Some assets or liabilities can be exchanged in multiple markets. For many assets and liabilities, one market is both the principal market and the most advantageous market.

If there is a principal market for the asset or liability, paragraph 12.6 requires the price in that market to be used when measuring fair value, even if the price in a different market is potentially more advantageous at the measurement date.

The principal market could change over time, for example, if there is a decrease in the volume or level of activity in that market, or if a new market becomes available.

An entity does not need to perform an exhaustive search for markets that might have more activity for the asset or liability than the market in which that entity normally enters into transactions. An entity can use the price in the market in which it normally enters into transactions to measure fair value, because it is reasonable to assume that an entity usually operates in the best market as a commercial decision. This assumption does not apply if there is evidence that the principal market is not the same as the SME's normal market.

Paragraph 12.7 states that an entity must have access to the market at the measurement date. However, there is no requirement that an entity must be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value based on the price in the market.

In addition to the example that follows, Case Study 1 on page 56 of this module provides a detailed example of determining the principal and most advantageous markets, including the consideration of transport and transaction costs.

Example—Principal or most advantageous market

Ex 11 An SME sells computers in two markets. More computers are bought and sold in Market A, but the SME has a greater volume and level of activity in Market B.

The principal market is determined based on the volume or level of activity for the asset, rather than on the volume or level of activity of the SME's transactions in a particular market.

Market A is the principal market for the asset. Therefore, the SME shall assume that the transaction to sell the computers takes place in Market A.

12.8 An entity shall ignore **transaction costs** when using the price in the principal (or most advantageous) market to measure the fair value of the asset or liability. Transaction costs are not a characteristic of an asset or a liability; instead, they are specific to a transaction.

12.9 If location is a characteristic of the asset, an entity shall adjust the price in the principal (or most advantageous) market for the costs, if any, that would be incurred to transport the asset from its current location to that market.

Educational notes

Section 12 treats transport costs differently from other costs associated with a sale transaction. In general, transaction costs are ignored in calculating fair value even though they are taken into account when assessing which market is the principal or most advantageous market.

However, transport costs, which are linked to the transaction, are included in fair value because the fair value takes the asset or liability's location into account. Two otherwise identical assets will have different fair values if one is in an isolated area and would be costly for the buyer to transport to their own location.

Example—Transaction costs

Ex 12 **An asset is sold in two active markets at different prices. An SME enters into transactions in both markets and can access the price in those markets for the asset at the measurement date.**

In Market A, the price that would be received is CU26, transaction costs in that market are CU3 and the costs to transport the asset to that market are CU2. Therefore, the net amount that would be received is CU21.[3]

In Market B, the price that would be received is CU25, transaction costs in that market are CU1 and the costs to transport the asset to that market are CU2. Therefore, the net amount that would be received is CU22.

If Market A is the principal market for the asset (that is, the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market (CU26) less transport costs (CU2), resulting in a fair value measurement of CU24.

If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (that is, the net amount that would be received in the respective markets).

The entity would maximise the net amount that would be received for the asset in Market B (CU22). Therefore, the fair value of the asset would be measured using the price in that market (CU25), less transport costs (CU2), resulting in a fair value measurement of CU23.

Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

3 In this example, and in all other examples in this module, monetary amounts are denominated in currency units (CU).

Highest and best use for non-financial assets

12.10 When making a fair value measurement of a non-financial asset, an entity shall take into account a market participant's ability to generate economic benefits by using the asset for its **highest and best use** or by selling it to another market participant that would use the asset for its highest and best use.

12.11 The highest and best use of a non-financial asset takes into account any use of the asset that is physically possible, legally allowed and financially feasible as follows:

(a) a use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (for example, the location or size of a property);

(b) a use that is legally allowed takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (for example, the zoning regulations applicable to a property); and

(c) a use that is financially feasible takes into account whether a use generates adequate **income** or **cash flows** that market participants would require from an investment in that asset put to that use.

12.12 An entity shall assume the current use of a non-financial asset is its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

12.13 If a non-financial asset provides maximum value to market participants through its use in combination with other assets (and liabilities), an entity shall assume the asset would be used with those other assets (and liabilities) and that those other assets (and liabilities) would be available to market participants. An entity shall make consistent assumptions about the highest and best use of a non-financial asset for all the assets (for which highest and best use is relevant) with which the asset would be used.

Definitions

The following definition is reproduced from the Glossary:

Highest and best use is the use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (for example, a business) within which the asset would be used.

Educational notes

Highest and best use is a valuation concept used to value non-financial assets. Highest and best use is determined from the perspective of market participants, even if the entity intends a different use for the asset. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

The highest and best use of a non-financial asset might provide maximum value through use either:

- in combination with other assets or other assets and liabilities; or
- on a stand-alone basis.

The highest and best use of a non-financial asset establishes whether its fair value should be measured on a stand-alone basis or as a group in combination with other assets and liabilities. If the highest and best use of the asset is to use it in combination with other assets and liabilities, it is assumed the market participant already holds those assets and liabilities. Liabilities associated with the assets (for the purpose of looking at the highest and best value of a group) include liabilities used for working capital but not more general financing loans that are used to fund assets outside that group. When looking at a group of assets and liabilities together, the entity's assumptions about highest and best use must be consistent for all the assets in the group.

There may be reasons that an entity does not use an acquired non-financial asset in its highest and best use. For example, an entity might plan to use an acquired intangible asset defensively by preventing others from using it (see Example 14 below).

The concept of highest and best use applies only to non-financial assets. It was originally developed within the valuation profession to value non-financial assets, such as land. The concept does not apply to financial assets or liabilities because:

- financial assets do not have alternative uses. A financial asset has specific contractual terms and its use can change only if the characteristics of the financial asset (that is, the contractual terms) are changed. However, a change in characteristics changes that asset into a different asset. The objective of a fair value measurement is to measure the asset that exists at the measurement date.
- an entity might be able to change the cash flows associated with a liability by relieving itself of the obligation in different ways, but these different ways of relief do not count as alternative uses. Moreover, although an entity might have entity-specific advantages or disadvantages that enable it to fulfil a liability more or less efficiently than other market participants, those entity-specific factors do not affect fair value.

Examples—Highest and best use

Ex 13 An SME applies the revaluation model in Section 17 *Property, Plant and Equipment* to its land and is therefore required to measure the fair value of the land applying Section 12. The land is currently developed for industrial use as a site for a factory. However, nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. Based on that development and recent zoning and other changes to facilitate the development, the SME determines that the land currently used as a site for a factory could be developed as a site for residential use (that is, for high-rise apartment buildings) and that market participants would take into account the potential to develop the site for residential use when pricing the land.

The current use of the land is assumed to be its highest and best use unless market or other factors suggest a different use. The SME has determined that market participants would take into account the potential to develop the site for residential use when pricing the land. In this case, the assumption regarding current use being the highest and best use might be rebutted if selling the land for residential use would maximise the fair value of the land.

Therefore, the highest and best use of the land would be determined by comparing two values:

- the value of the land as currently developed for industrial use. In this case, the land is used in combination with other assets, such as the factory, or with other assets and liabilities.
- the value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs necessary to convert the land to a vacant site (taking into account uncertainty about whether the SME could convert the asset to the alternative use). In this case, the land is to be used by market participants on a stand-alone basis.

The highest and best use of the land would be determined based on the higher of those values. In situations involving real estate appraisal, the determination of highest and best use might take into account factors relating to the factory's operations, including its assets and liabilities, instead of looking at the factory as if it were an empty unused building.

Ex 14 An SME acquires a research and development (R&D) project in a business combination. The SME does not intend to complete the project. If completed, the project would compete with one of its own projects that is already in development to provide the next generation of its commercialised technology. Instead, the SME intends to stop development of (that is, lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the SME's own competing technology.

At the acquisition date, the SME recognises, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree applying Section 19. Assuming that the fair value of the R&D project can be measured reliably without undue cost or effort at the acquisition date, the SME would need to measure the fair value of the R&D project at initial recognition.

The highest and best use of the project would be determined based on its use by market participants. For example:

(a) the highest and best use of the R&D project would be to continue development if market participants would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used (that is, the asset would be used in combination with other assets or with other assets and liabilities). That might be the case if market participants do not have similar technology, either in development or commercialised. The fair value of the project would be measured based on the price that would be received in a current transaction to sell the project, assuming that the R&D would be used with its complementary assets and associated liabilities and that those assets and liabilities would be available to market participants.

(b) the highest and best use of the R&D project would be to cease development if, for competitive reasons, market participants would also lock up the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used. That might be the case if market participants have technology in a more advanced stage of development that would compete with the project if completed and the project would be expected to improve the prospects for their own competing technology if locked up. The fair value of the project would be measured based on the price that would be received in a current transaction to sell the project, assuming that the R&D would be locked up with its complementary assets and the associated liabilities and that those assets and liabilities would be available to market participants.

(c) the highest and best use of the R&D project would be to cease development if market participants would discontinue its development for other reasons, for example, if the project is not expected to provide a market rate of return if completed and would not otherwise provide defensive value if locked up. The fair value of the project would be measured based on the price that would be received in a current transaction to sell the project on its own (which might be zero).

Valuation techniques

12.14 If a price for an identical asset or liability is not observable, an entity shall measure fair value using another valuation technique. The entity shall use a valuation technique that is appropriate in the circumstances and for which sufficient data is available to measure fair value. The entity shall maximise its use of relevant **observable inputs** and minimise its use of **unobservable inputs**.

12.15 Three widely used valuation approaches are the market approach, the cost approach and the income approach. An entity shall use a valuation technique consistent with one or more of these approaches:

(a) *the market approach* uses as inputs the prices and other relevant information generated by market transactions involving identical or similar assets, liabilities or a group of assets and liabilities, such as a **business**. For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables.

(b) *the cost approach* calculates the amount that would be required currently to replace the service capacity of an asset (often called 'current replacement cost').

(c) *the income approach* converts future amounts (for example, cash flows or income and **expenses**) to a single current (that is, discounted) amount. Valuation techniques using the income approach include:

(i) **present value** techniques;

(ii) option pricing models; and

(iii) the multi-period excess earnings method, which is used to measure the fair value of some **intangible assets**.

Definitions

The following definitions are reproduced from the Glossary:

Observable inputs are inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

Unobservable inputs are inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

Educational notes

Using valuation techniques

Paragraph 12.3 states that the objective of a fair value measurement is to estimate the price at which an orderly transaction (not a forced transaction) to sell an asset or to transfer a liability would take place between market participants at the measurement date under current market conditions.

A valuation technique should incorporate the factors that market participants would consider in setting a price and should be consistent with accepted valuation approaches. Choosing and applying valuation techniques often involves a significant amount of judgement.

Section 12 does not contain a hierarchy of valuation techniques because particular valuation techniques might be more appropriate in some circumstances than in others. Therefore, an entity selects valuation techniques that are appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

Adjustments should be made to the output of a valuation technique or to the inputs to a valuation technique if they do not capture factors that market participants would take into account when pricing an asset or a liability at the measurement date, including assumptions about risk.

In some cases, a single valuation technique will be appropriate, for example, 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, for example, when valuing a cash generating unit which comprises several assets and liabilities. If multiple valuation techniques are used to measure fair value, the results (that is, the estimations of fair value for each) shall be evaluated 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.

If an entity makes significant use of valuation techniques, it is good practice to periodically test the techniques for validity using prices from observable current market transactions in the same instrument (without modification or repackaging) or using any available observable market data.

Some SMEs may lack the expertise to perform complex valuations. In such cases, an SME might use a third-party valuation specialist. The SME will still need to ensure that the third-party valuation is made in accordance with the requirements in Section 12.

The three valuation approaches

Paragraph 12.15 identifies three widely used valuation approaches: the market approach, the cost approach and the income approach. Individual valuation techniques belong to one of these three approaches. For example, the multi-period excess earnings method is a valuation technique that falls into the income approach. The choice of approach should take into account the type of asset and the information that is available.

Market approach

The market approach uses as inputs the prices and other relevant information generated by market transactions involving identical or similar assets.

Valuation techniques consistent with the market approach often use sector benchmarks (for example, the value of an orchard expressed per hectare or value of cattle expressed per kilogram of meat) or market multiples derived from a set of comparables (for example, price-to-book ratio derived from similar companies or price per square metre for properties in a similar location).

Cost approach

The cost approach calculates the current replacement cost, that is, the amount that would be required currently to replace the service capacity of an asset. 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. This approach assumes that a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

The current replacement cost method might be an appropriate method to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities, for example, installed equipment on a production line that has been significantly customised.

Income approach

The income approach measures an asset considering the income it will generate discounted for the time value of money and associated risks. Common valuation techniques under the income approach include:

(a) option pricing models, such as the Black-Scholes-Merton formula or a binomial model (that is, a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and

(b) present value techniques that link future amounts (for example, values or cash flows) to a present amount using a discount rate.

SMEs will be familiar with present value techniques because present value calculations are used in other sections of the Standard, for example:

(a) if the effect of the time value of money is material, the amount of a provision is measured at the present value of the amount expected to be required to settle the obligation (see paragraph 21.7 in Section 21 *Provisions and Contingencies*); and

(b) value in use is the present value of the future cash flows expected to be derived from an asset (see paragraph 27.15 in Section 27 *Impairment of Assets*).

Some present value calculations, such as the two above, are entity-specific. For example, the discount factor for value in use is based on the entity's individual borrowing capability and the assumptions in determining the discount factor reflect the entity's specific plans for the asset or group of assets.

Paragraph 12.3 states that fair value is a market-based measurement rather than an entity-specific measurement. Section 12 performs the present value calculation from the perspective of market participants rather than the reporting entity. This means that the cash flows and discount rates used in the present value calculations should reflect assumptions that market participants would use when pricing the asset or liability, and should not take into account any entity-specific assumptions.

Therefore, an entity applying present value techniques in determining the fair value of an asset applying Section 12 is not performing the same calculation as it would if it were performing an impairment review applying Section 27.

A fair value measurement of an asset or a liability using a present value technique should capture certain 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 timing of the cash flows (representing the uncertainty inherent in the cash flows);

(c) the time value of money, represented by a risk-free interest rate, that is, the rate on risk-free monetary assets with 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;

(d) the price for bearing the uncertainty inherent in the cash flows (that is, the risk premium); and

(e) other factors that market participants would take into account in the circumstances.

Present value techniques differ in how they capture these elements. However, the application of any present value technique used to measure fair value is governed by certain general principles:

- cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability.
- cash flows and discount rates should take into account only the factors attributable to the asset or liability being measured.
- to avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with the assumptions inherent in the cash flows. For example, a discount rate that reflects the uncertainty in expectations about future defaults is appropriate if an entity is estimating the fair value of a loan using its contractual cash flows (that is, a discount rate adjustment technique). That same rate should not be used if using expected cash flows (that is, an expected present value technique using probability weighting) because the expected cash flows already reflect assumptions about the uncertainty in future defaults. Instead, a discount rate that is commensurate with the risk inherent in the expected cash flows should be used.
- assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows, which include the effect of inflation, should be discounted at a rate that includes the effect of inflation, for example, the nominal risk-free interest rate. Real cash flows, which exclude the effect of inflation, should be discounted at a rate that excludes the effect of inflation. Similarly, after-tax cash flows should be discounted using an after-tax discount rate. Pre-tax cash flows should be discounted at a rate consistent with those cash flows.
- discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

Section 12 does not prescribe the use of a single specific present value technique, nor does it limit 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 (for example, whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data.

Paragraphs B13–B30 of IFRS 13 provide detailed guidance on how present value techniques might be used to measure fair value. Those paragraphs focus on two present value techniques: a discount rate adjustment technique and an expected cash flow (expected present value) technique.

How to read the examples below

Section 12 does not prescribe a specific valuation technique, but instead encourages entities to use professional judgement and to consider all facts and circumstances surrounding the measurement. The examples below illustrate, in a general way, one possible thought process for measuring fair value in accordance with the principles set out in Section 12. The examples are not intended to present a single 'right' answer for a particular set of circumstances: other valuation techniques might be appropriate depending on facts and circumstances specific to the asset or liability being measured and the availability of data.

Examples—Market approach

Ex 15 An SME owns an investment property in the city. Similar properties in the city have been sold and their sales prices are publicly available.

Section 16 requires investment property to be measured, after initial recognition, at fair value if fair value can be measured reliably without undue cost or effort.

The market approach is likely to be an appropriate valuation approach for the investment property because sufficient data exists to measure fair value (available prices for sales of similar properties) and the market approach would maximise the entity's use of relevant observable inputs (the prices are publicly available).

Using the market approach, the SME would measure the fair value of the investment property applying Section 12 by reference to the prices achieved in sales of comparable properties in the local real estate market. The reference prices might need to be adjusted for differences between the comparable properties and the SME's investment property, for example, differences in the location, size, condition and amenities. Some of these differences are directly measurable (for example, sales price and size) and would be categorised as observable inputs for purposes of the value adjustment. Other differences are likely to be more subjective (for example, condition and location) and would therefore be categorised as unobservable inputs to the value adjustment.

Ex 16 An SME owns a fleet of vehicles that it uses to deliver its products. The SME has stopped using one truck in the fleet because of its low fuel efficiency. The SME determines that the change in use is an internal indicator that the truck is impaired and estimates the recoverable amount of the truck applying Section 27 *Impairment of Assets*. The market price for similar trucks in an active resale market is CU6,000. Fees associated with selling the truck are CU200.

The SME has stopped using the truck and so it seems clear that the truck's fair value less costs to sell is higher than its value in use, which is now minimal.

When measuring fair value less costs to sell, the SME applies the guidance on measuring fair value in Section 12 and deducts the costs of disposal (paragraph 27.14 of the Standard).

The market approach is appropriate in these circumstances because sufficient data exists to measure fair value (active resale market for the truck) and the market approach would maximise the entity's use of relevant observable inputs (publicly available prices for trucks).

The recoverable amount of the truck is CU5,800 = fair value (CU6,000) – costs to sell (CU200).

Ex 17 An SME cultivates sugar cane (biological asset). The SME sells its harvested cane to local ethanol manufacturing plants at the international market price of sugar cane on the day of delivery to the ethanol plant.

At 31 December 20X0 the SME's 200-hectare cane plantation is ready for harvest. Management expects that the costs of harvesting are CU3 per tonne.

The sector benchmark productivity is 70 tonnes of harvested sugar cane per hectare for farmers that grow the same type of cane on similar land, using the same inputs, methods and technologies, and in the same area as the SME. In past years the SME's harvest has approximated the sector benchmark and management has no reason to believe that this year's harvest will deviate from that benchmark.

At 31 December 20X0 (the SME's reporting date) sugar cane traded on the international market at CU15 per tonne. Costs to transport the harvested cane to the ethanol manufacturing plants are estimated at CU1 per tonne.

Section 34 *Specialised Activities* requires biological assets in its scope (such as sugar cane) to be measured at fair value less costs to sell.

On the basis of the sector benchmark, the SME expects to harvest 14,000 tonnes of sugar cane = hectares (200) × tonnes per hectare (70).

At 31 December 20X0, the SME determines the fair value of the sugar cane that has not yet been harvested to be CU154,000 = tonnes (14,000) × CU11 (market price of harvested cane (CU15) – harvesting costs (CU3) – costs to transport the cane to the ethanol manufacturing plants (CU1)).

Note that the entity takes the costs of harvesting into account in determining the fair value of the unharvested cane. It deducts those costs from the market price for harvested cane (see paragraph 12.5). The entity also deducts transport costs because location is a characteristic of sugar cane (see paragraph 12.9).

Ex 18 **An SME owns 250 ordinary shares in Company X, an unquoted company. Company X has a total share capital of 5,000 shares with nominal value of CU10. Company X's after-tax maintainable profits are estimated at CU70,000 per year.**

An appropriate price/earnings ratio determined from published industry data is 15 (before lack of marketability adjustment). The SME's management estimates that the discount for the lack of marketability of Company X's shares and restrictions on their transfer is 20%. The SME values its holding of Company X's shares based on earnings.

Section 11 requires investments in non-puttable ordinary shares to be measured at fair value if fair value can be measured reliably without undue cost or effort.

A valuation of the SME's holding of shares in Company X might be performed using the comparable price/earnings ratio as follows:

Value of Company X (CU840,000) = CU70,000 × comparable price/earnings ratio (15) × discount for lack of marketability (0.8).

Share price (CU168) = value of Company X (CU840,000) ÷ total shares (5,000).

The fair value of the SME's investment in Company X's shares is estimated at CU42,000 = holding of shares (250) × share price (CU168). This valuation technique is consistent with the market approach using a comparable price/earnings ratio.

Example—Cost approach

Ex 19 **On 1 January 20X2, SME B purchased a machine customised for its purposes for CU10,000. The machine was significantly customised for SME B's business and there are no identical or similar items available in the market. On 31 December 20X5, SME B was acquired by SME A. SME A recognises the identifiable assets and liabilities of SME B at fair value at the acquisition date of 31 December 20X5 in accordance with Section 19.**

In order to measure the fair value of the machine customised for SME B's purposes, SME A obtains price lists for other items of machinery held by SME B and determines that the prices have risen by 15% between 1 January 20X2 and 30 December 20X5. SME A considers this to be a reasonable approximation of the increase in price for the customised machine.

SME A estimates the cost of replacing the machine with a new identical customised machine to be CU11,500 = initial cost of the machine (CU10,000) × price increase (1.15). SME A also estimates that the current customised machine should be measured at 80% of this cost to take obsolescence into account.

Therefore, the fair value of the specialised machinery is determined to be CU9,200 = CU11,500 × obsolescence adjustment (0.8).

The adjustments are inherently subjective and assume that customised machines are subject to the same changes in value as other machines. The adjusted figures would be categorised as Level 3 inputs (see paragraph 12.27) and are used because there is no more reliable data available to adjust the (observable) historical cost of the customised machine.

Example—Income approach

Ex 20 **On 31 December 20X4, an SME holds an investment in cumulative preference shares issued by an unlisted company. There are no published prices available for the shares but the SME knows that it will receive a fixed annual dividend for five years and that the shares will then be redeemed at par.**

In the SME's view, an income approach is the best valuation technique. The SME determines the present value of expected cash flows using the committed dividend and redemption amounts.

These expected inflows are discounted to reach an estimate of present value. Because Section 12 requires the calculation to be from the perspective of market participants, and not of the SME, the discount rates used are based on commercially available lending rates rather than reflecting the financing available to the SME.

Example—Multiple valuation approaches

Ex 21 **The facts are the same as in Example 18. However, in this example, the SME estimates the fair value of the shares it owns in Company X using a net asset valuation technique. The fair value of Company X's net assets, including those recognised in its statement of financial position and those that are not recognised, is CU850,000.**

Share price (CU170) = fair value of net assets (CU850,000) ÷ shares (5,000).

The fair value of the SME's investment in Company X's shares is estimated to be CU42,500 = shares (250) × share price (CU170).

Application of the net asset valuation technique often uses a combination of the valuation approaches in paragraph 12.15. This is because different valuation techniques would likely be used to measure the fair value of each of Company X's assets and liabilities in order to determine the total fair value of Company X's net assets.

12.16 An entity shall account for revisions resulting from a change in the valuation technique or a change in its application as a change in **accounting estimate** in Section 10. However, an entity is not required to apply the disclosure requirements in Section 10 for a change in accounting estimate resulting from a change in a valuation technique or its application.

Educational notes

In general, measurement techniques should be applied consistently and the same applies to valuation techniques. If an entity is inconsistent in its choice of techniques, the information in its financial statements might not be as relevant and give such faithful representation as if consistent techniques were used. However, a change in a valuation technique or its application (for example, a change in weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) 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;
- valuation techniques improve; or
- market conditions change.

A change in valuation technique may also be appropriate for the entity to maximise its use of relevant observable inputs and minimise its use of unobservable inputs.

Section 10 *Accounting Policies, Estimates and Errors* requires that if a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, the entity shall recognise it by adjusting the carrying amount of the related asset, liability or equity item in the period of the change (see paragraph 10.17 of the Standard).

Example—Change in valuation technique

Ex 22 An SME owns an investment property in a remote area of countryside. Before 20X1, the SME measured the fair value of the property using an income approach because of lack of market data. However, recently there has been significant development in the area of the property and the SME decides to use a market approach (sales of comparable properties) to value the property. The SME notes that using the market approach would maximise its use of relevant observable inputs and minimise its use of unobservable inputs.

The SME determined the fair value of the investment property at its 20X0 year-end (31 December 20X0) to be CU200,000 using an income approach. The SME determined the fair value of the property at its 20X1 year-end (31 December 20X1) to be CU255,000 based on sales of comparable properties in the surrounding area (with adjustments made for differences in condition or location of the properties).

The SME applies paragraph 10.17 of the Standard to the change in the valuation technique by adjusting the carrying amount of the investment property in the period of the change (that is, in 20X1).

The change in the fair value of the investment property due to a change in the valuation technique is part of the overall change in fair value of the investment property.

The SME recognises any change in the fair value of the investment property in the period in profit or loss applying paragraph 16.8 of the Standard.

The increase in the fair value of CU55,000 (= fair value at 20X1 year-end (CU255,000) – fair value at 20X0 year-end (CU200,000)) is recognised as an increase in the carrying amount of the investment property and as a gain in profit or loss for 20X1.

There is no requirement for the portion of the gain of CU55,000 relating to the change in valuation technique to be disclosed separately. Changes in fair value arising from changes in valuation technique are excluded from the disclosure requirements in Section 10 for changes in accounting estimates.

12.17 An asset or a liability measured at fair value might have a bid price and an ask price (for example, an input from a dealer market). If so, an entity shall measure the fair value of the asset or liability using the price within the bid–ask spread that is most representative of fair value in the circumstances. The entity shall use this price to measure fair value regardless of how the entity categorises the input within the fair value hierarchy (that is Level 1, Level 2 or Level 3; see paragraphs 12.22–12.27). The entity is permitted, but not required, to use the bid prices for asset positions and ask prices for liability positions. This section does not preclude an entity from using mid-market pricing or other pricing conventions, within a bid–ask spread, that are used by market participants as a practical expedient for fair value measurements.

Educational notes

Bid–ask spreads are only relevant for financial instruments and in markets in which an intermediary (for example, a broker) is necessary to bring together a buyer and a seller to engage in a transaction—that is, when the buyer and seller need an intermediary to find one another.

When measuring the fair value of a non-financial asset or non-financial liability, the notion of a bid–ask spread is not relevant because the buyers and sellers in the principal (or most advantageous) market have already found one another and are assumed to have negotiated the transaction price—that is, fair value.

Reliable measure of fair value

12.18 A valuation technique would be expected to arrive at a reliable **measure** of fair value if:

(a) the technique reasonably reflects how the market could be expected to price the asset; and

(b) the technique's inputs reasonably represent market expectations and measures of the risk return factors inherent in the asset.

12.19 The fair value of investments in assets that do not have a quoted market price in an **active market** is reliably measurable if:

(a) the variability in the range of reasonable fair value measures is not significant for that asset; or

(b) the probabilities of the various measures within the range can be reasonably assessed and used to estimate fair value.

12.20 The variability in the range of reasonable fair value measures of assets that do not have a quoted market price is likely not to be significant in many situations. Normally an entity can estimate the fair value of an asset acquired from an outside party. However, if the range of reasonable fair value measures is significant and the probabilities of the various measures cannot be reasonably assessed, then a reliable measure of fair value is not available.

12.21 If a reliable measure of fair value is no longer available for an asset measured at fair value (or is not available without undue cost or effort when an undue cost or effort exemption is provided—for example, see paragraphs 11.14(c) and 11.54(b)), an entity shall instead use its **carrying amount** at the last date the asset was reliably measurable as its new cost. An entity shall measure the asset at this cost amount less **impairment** until a reliable measure of fair value is available (or is available without undue cost or effort when such an exemption is provided).

Educational notes

When a section of the Standard requires measurement at fair value, paragraphs 12.18–12.20 of Section 12 help entities to establish whether a particular valuation technique would be expected to provide a reliable measure of fair value.

Many sections of the *IFRS for SMEs* Accounting Standard provide an undue cost or effort exemption relating to determining a reliable measure of fair value. For example:

- investments in non-convertible preference shares and non-puttable ordinary or preference shares shall be measured:
  - at fair value if the shares are publicly traded or their fair value can otherwise be measured reliably without undue cost or effort; and
  - at cost less impairment otherwise (see paragraph 11.14(c) in Section 11 of the Standard);

- only investment property whose fair value can be measured reliably without undue cost or effort on an ongoing basis shall be measured at fair value through profit or loss applying Section 16 *Investment Property*; and
- only biological assets in the scope of Section 34 *Specialised Activities* whose fair value can be measured reliably without undue cost or effort shall be measured at fair value less costs to sell.

Therefore, where a section of the Standard requires an asset or liability to be measured at fair value, an entity follows this requirement unless:

- no reliable measure of fair value is available; or
- a reliable measure of fair value is available, but would require undue cost or effort.

The requirements for an undue cost or effort exemption are included in paragraphs 2.28–2.31 of Section 2 *Concepts and Pervasive Principles*.

If a section of the Standard requires measurement at fair value and no undue cost or effort exemption is provided, the assumption is that it is possible for the SME to reach a reliable measure of fair value. In some situations, if an SME cannot determine fair value, it can choose the alternative of not using a revaluation policy at all but instead holding the asset at depreciated cost. This choice might be available, for example, in applying a revaluation policy for property, plant and equipment, and the decision to use it would be a policy choice, not an application of the undue cost or effort exemption.

An entity cannot apply the undue cost or effort exemption by analogy. The exemption is only available where it is explicitly specified.

An entity will revert to measuring an asset or liability at fair value once a reliable measure becomes available. The change between the previous carrying amount and the fair value when this measure becomes available will be treated in accordance with the requirements in the relevant section of the Standard relating to changes in fair value.

Example—Reliable measure of fair value is available but requires undue cost or effort

Ex 23 SME A owns a 5% interest in Company B, a local start-up whose shares are unlisted and not traded on any exchange. Company B has never been subject to an external valuation, its business model is still in the development stage, and only limited financial information is available. For SME A to determine the fair value of its investment, it would need to engage a specialist valuer at a cost that would exceed the returns SME A has received from the investment since its acquisition three years ago.

SME A considers whether fair value can be reliably determined without undue cost or effort. Management noted the absence of an active market and the speculative nature of the available forecasts. The external valuation would give a reliable measure of fair value, but at a disproportionate cost. On this basis, SME A concludes that the undue cost or effort exemption applies, so SME A applies paragraph 11.14(c) in Section 11 of the Standard and measures the investment in Company B at cost less impairment instead of at fair value.

Example—Reliable measure of fair value is not available

Ex 24 **The facts are as in Example 23 but the SME has approached several professional valuers, all of whom say they cannot provide an estimate of fair value, only a wide range of estimates. The valuers have indicated that they would be unable to assign probabilities to the outcomes within the range.**

The SME concludes that a reliable measure of fair value is not available because even engaging professional valuers would give only a range of estimates and there is no reasonable way to assign probability to these. On this basis, the SME holds the investment at cost less impairment instead of at fair value.

Fair value hierarchy

12.22 For consistency and comparability in fair value measurements and related disclosures, an entity shall apply a fair value hierarchy, categorising the inputs to valuation techniques used to measure fair value into three levels—Level 1, Level 2 and Level 3. This fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs). In some cases, an entity might categorise the inputs used to measure the fair value of an asset or a liability within different levels of the fair value hierarchy. In these cases, an entity shall categorise the entire fair value measurement at the level of the lowest level input that is significant to the entire measurement.

Educational notes

The levels introduced in paragraph 12.22 make a hierarchy that was already in place in parts of the Standard explicit and general. In the previous editions of the Standard, the section on financial instruments required an entity seeking to measure fair value to consult evidence in order of precedence:

- first, quoted prices for an identical or similar asset in an active market;
- if quoted prices were unavailable, prices in a binding sale agreement for an identical or similar asset;
- if such evidence from sales agreements was unavailable, another valuation technique to permit the SME to estimate fair value.

The hierarchy is therefore not new in the third edition of the Standard but it has now been clarified and better explained so that it applies also to non-financial assets and liabilities. The hierarchy is now consistent across the Standard and across SME financial statements, reducing pressure on SMEs to devise their own systems, and the standardised disclosures help users to understand how fair value is established throughout the financial statements.

Assessing the significance of a particular input for the entire measurement requires judgement, taking into account factors specific to the asset or liability.

Adjustments to arrive at measurements based on fair value, such as costs to sell (when measuring fair value less costs to sell), shall not be taken into account when determining the level of the fair value hierarchy within which a fair value measurement is categorised.

Level 1 inputs

12.23 Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. A quoted price in an active market provides the most reliable evidence of fair value. An entity shall use a quoted price in an active market to measure fair value whenever such a price is available.

12.24 If an entity holds a position in a single asset or liability (including a position comprising many identical assets or liabilities, such as a holding of **financial instruments**) and the asset or liability is traded in an active market, the entity shall measure the fair value of the asset or liability by multiplying the quoted price for the individual asset or liability by the quantity it holds. The fair value measurement of the asset or liability would be categorised within Level 1.

Definitions

The following definition is reproduced from the Glossary:

An **active market** 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.

Educational notes

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities. The entity must be able to access these markets at the measurement date. A clear example is an investment in equity that is listed on an active stock exchange.

When assessing whether the market is active, an entity considers the trading activity for the security in the market in which it is traded, rather than the general activity in the market. For example, a security listed on the London Stock Exchange could be considered to be traded in an inactive market if that particular security is traded infrequently.

Examples of factors that might indicate a significant decrease in the volume or level of activity for the security include:

- sparse transactions for the security;
- price quotations that are not developed using current information;
- price quotations that vary substantially either over time or among market-makers (for example, in some brokered markets); and
- a wide bid–ask spread or significant increase in the bid–ask spread.

A fair value measurement can only be categorised as Level 1 in the fair value hierarchy if it is based on a market approach where the inputs are only unadjusted quoted prices in an active market for an identical asset or liability.

Level 1 inputs will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets (for example, on different exchanges). Therefore, the emphasis within Level 1 is on determining both of the following:

- 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; and
- whether the entity could enter into a transaction for the asset or liability at the price in that market at the measurement date.

Example—Level 1 input

Ex 25 SME A holds shares in Company B. Company B is listed on the London Stock Exchange.

Company B's unadjusted share price on the London stock exchange is a Level 1 input.

The fair value measurement of SME A's holding of shares in Company B will be categorised as Level 1 in the fair value hierarchy. A quoted price in an active market is available and provides the most reliable evidence of fair value. Applying the Standard, an entity shall use a quoted price in an active market to measure fair value whenever such a price is available.

Level 2 inputs

12.25 Level 2 inputs are directly or indirectly observable inputs—other than quoted prices included within Level 1—for the asset or liability. Level 2 inputs include:

(a) quoted prices in active markets for assets or liabilities that are similar to the asset or liability.

(b) quoted prices in markets that are not active for assets or liabilities that are similar or identical to the asset or liability.

(c) observable inputs other than quoted prices for the asset or liability—for example:

(i) interest rates and yield curves observable at commonly quoted intervals;

(ii) implied volatilities; and

(iii) credit spreads.

(d) market-corroborated inputs.

12.26 If an entity adjusts a Level 2 input in a way that is significant to the entire measurement and uses significant unobservable inputs, the entity might need to categorise the fair value measurement within Level 3 of the fair value hierarchy.

Educational notes

The category of Level 2 inputs is applicable for fair value measurements that can be based on observable inputs but are not unadjusted quoted prices (and therefore do not qualify as Level 1 inputs). This category might be particularly useful for SMEs that have assets or liabilities for which unadjusted quoted prices (Level 1 inputs) are unavailable, but for which quoted prices for similar assets or liabilities are available.

Examples of Level 2 inputs for particular assets and liabilities include:

- *building held and used*—the price per square metre for each building (a valuation multiple) derived from observable market data, for example, multiples derived from prices in observed transactions involving comparable buildings in similar locations.
- *cash-generating unit*—valuation multiples (for example, a multiple of earnings or revenue or a similar performance measure) derived from observable market data, such as prices in observed transactions involving comparable businesses, taking into account operational, market, financial and non-financial factors.
- *finished goods inventory at a retail outlet (acquired in a business combination)*—either the price to customers in a retail market or the price to retailers in a wholesale market, adjusted for differences in the condition and location of the inventory item and those of comparable 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 selling efforts. Conceptually, the fair value measurement will be the same whether adjustments are made downward from a retail price or upward from a wholesale price. In practice, the price that requires the least amount of subjective adjustment is used for the fair value measurement.
- *receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate*—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.

Further examples are provided in paragraph B35 of IFRS 13.

Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability, for example, the condition or location of the asset (see paragraph 12.5). The condition or location of the asset might, for example, require an adjustment for transport costs or an adjustment to reflect a lower quality of the assets than comparable assets in the market.

If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy.

Examples—Level 2 inputs

Ex 26 An SME determines the fair value of an investment property using a price per square metre that has been derived from prices in observed transactions for similar buildings in a similar location.

The price per square metre derived from prices in observed transactions for similar buildings in a similar location is a Level 2 input.

The fair value measurement of the investment property would be categorised in Level 2 of the fair value hierarchy, unless the measurement requires an adjustment using an unobservable input (Level 3 input) and that adjustment results in a significantly higher or lower fair value measurement.

Ex 27 An SME determines the fair value less costs to sell of a cash-generating unit in order to determine the recoverable amount of the unit for impairment testing applying Section 27. The SME uses a valuation multiple of earnings derived from prices in observed transactions involving comparable businesses (market approach).

A valuation multiple of earnings derived from prices in observed transactions involving comparable businesses is a Level 2 input.

The fair value measurement of the cash-generating unit would be categorised in Level 2 of the fair value hierarchy, unless the measurement requires an adjustment using an unobservable input (Level 3 input) and that adjustment results in a significantly higher or lower fair value measurement.

Level 3 inputs

12.27 Level 3 inputs are unobservable inputs for the asset or liability. An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity is permitted to begin with its own data, but the entity shall adjust this data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (for example, an entity-specific synergy). An entity need not make exhaustive efforts to obtain information about market participant assumptions. However, an entity shall take into account all information about market participant assumptions that is reasonably available.

Educational notes

Level 3 inputs represent fair value measures where little or no external information is available—that is, observable inputs are not available. Many SMEs might find they do not have observable inputs for assets and liabilities and will therefore use this category.

Paragraph 12.27 of Section 12 explains how an SME uses unobservable inputs and adjusts this data.

Examples of Level 3 inputs for particular assets and liabilities include:

- *cash-generating unit*—financial forecasts for the unit (for example, of cash flows or profit or loss). The accompanying financial assumptions, such as the discount rate or the long-term revenue growth rate, should be observable inputs available to market participants—that is, market participant assumptions. If there is reasonably available information that indicates that market participants would use different assumptions, then the forecast would use the entity's own data.
- *decommissioning liabilities assumed in a business combination*—a current estimate of the future cash outflows to be paid to fulfil the obligation (including market participants' expectations about the costs of fulfilling the obligation and the compensation that a market participant would require for taking on the obligation to dismantle the asset). If the effect of the entity's credit standing on the fair value of the liability would be reflected in the discount rate available to market participants, the current estimate would be used in a present value technique together with other inputs, for example, a current risk-free interest rate or a credit-adjusted risk-free rate. The fair value measurement would then be using a market participant assumption, rather than a simple estimate of future cash outflows. The estimate is made using the entity's own data unless there is reasonably available information that indicates that market participants would use different assumptions.
- *interest rate swap*—an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that is not directly observable and cannot otherwise be corroborated by observable market data.

Example—Level 3 inputs

Ex 28 **An SME holds a field of sunflowers that will be ready to harvest and sell two months after the reporting date. The sunflowers are classified as biological assets and are in the scope of Section 34 of the Standard.**

The SME values the sunflowers using the present value of expected sales proceeds. These expected proceeds are based on its estimate of yield and obtainable prices. Because the SME's reporting date is two months before harvest, the estimate also takes into account expectations about the weather in the coming period as weather can significantly affect crop value.

Market participants would be able to access some price information for a typical harvest, but this year's prices will not yet be observable at the reporting date, nor will the impact of the weather. Therefore, significant unobservable inputs (Level 3 inputs) will be required to make an estimate of present value.

The fair value of the SME's sunflower field would therefore be categorised in Level 3 of the fair value hierarchy because it uses unobservable inputs.

Disclosures

12.28 An entity shall disclose for each **class of assets** and liabilities measured at fair value in the **statement of financial position** after initial **recognition**:

(a) the carrying amounts 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, Level 2 or Level 3); and

(c) a description of the valuation technique(s) the entity used for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, and the inputs used in the fair value measurement.

12.29 For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, an entity shall disclose total gains or losses for the period recognised in:

(a) **profit or loss**, and the line items in profit or loss in which those gains or losses are recognised; and

(b) **other comprehensive income**, and the line items in other comprehensive income in which those gains or losses are recognised.

12.30 An entity shall determine appropriate classes of assets and liabilities on the basis of:

(a) the nature, characteristics and risks of the asset or liability; and

(b) the level of the fair value hierarchy within which the fair value measurement is categorised.

12.31 A class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position; however, an entity shall disclose sufficient information to permit reconciliation to the line items presented in the statement of financial position.

12.32 An entity shall present the quantitative disclosures required by paragraphs 12.28–12.31 in a table unless another format would be more useful.

Educational notes

The aim of the disclosure requirements is to give users an understanding of where in the financial statements fair values have been used, where movement in those values is reported and how the fair values are determined. The Standard gives some guidance on a suitable level of aggregation for the disclosure requirements. The requirements to disclose the level in the hierarchy let users understand how objective the fair value measurements are and which techniques were used.

In addition to the disclosures required by Section 12, an entity should consider whether disclosures are required about significant estimates and other judgements management has made when performing fair value measurements or preparing disclosures about fair value measurements (see page 47 of this educational material).

An entity is required to disclose the valuation method used and the inputs used. Such disclosures will be specific to the entity and the item being valued. The disclosures in the examples below are for reference only. Entities should explain their specific facts and circumstances and add additional information, where relevant for users of the financial statements, to enhance the quality of the disclosures.

Example 27 shows how the quantitative amounts might be presented in a table. Other formats can be used instead if the entity thinks they are more useful. For example, Example 28 shows how additional narrative disclosure could be provided to help users of financial statements understand the quantitative amounts.

Note that complex fair value calculations could materially affect an entity's financial results. Paragraph 3.2 of the Standard requires an entity to disclose additional information if compliance with the specific requirements in this Standard is insufficient to enable users to understand the effects of particular transactions, other events and conditions on the entity's financial position and financial performance. An entity would need to assess whether additional disclosures would be required under this requirement.

Examples—Quantitative disclosures in paragraphs 12.28–12.32 presented in a table

Ex 29 Extract from notes to SME's financial statements for the year ended 31 December 20X5

Note 12 Fair value measurements

Fair value measurements at the end of the reporting period categorised using the fair value hierarchy (amounts in CU):

Description	Fair value at 31 Dec 20X5	Level 1	Level 2	Level 3	Level 3 Total gains / losses[(a)]
Investments in equity instruments	50,000				
- Shares in A Limited		20,000			
- Shares in B Limited				30,000	2,000
Investment property	350,000				
- Area A			200,000		
- Area B				150,000	30,000

Valuation techniques and inputs used in fair value measurements:

Description	Fair value at 31 Dec 20X5 CU	Valuation technique(s)	Inputs	Range (weighted average)
Investments in equity instruments				
- Shares in A Limited	20,000	Quoted price of A Limited shares	N/A	N/A
- Shares in B Limited	30,000	Discounted cash flow	Weighted average cost of capital (discount rate)	7%–16% (12.1%)
				2%–5% (4.2%)
			Long-term revenue growth	3%–20% (10.3%)
				5%–20% (17%)
			Long-term pre-tax operating margin	
			Discount for lack of marketability	

continued ...

... continued				
		Market comparable companies	EBIDTA multiple Revenue multiple Discount for lack of marketability	10–13 (11.3) 1.5–2.0 (1.7) 5%–20% (17%)
Investment property - Area A - Area B		Market comparable approach Market comparable approach	Recent sales of comparable properties in same building Price per square metre	CU180,000–CU220,000 CU3,000–CU7,000 (CU4,500)
(a) Total gains and losses are recognised in profit or loss for the period and included in the line item 'other financial income'.				

Note that this example shows the disclosures for the year ended 31 December 20X5. Comparative information would also be required for the prior year (except in the reporting period in which an entity first applies the Standard).

Example—Qualitative disclosures to support quantitative amounts in paragraph 12.28(c)

Ex 30 Extract from notes to SME B's financial statements for the year ended 31 December 20X2

The fair value of apple trees is measured at the present value of the expected net cash flows from the tree, and this measurement is categorised as Level 3 in the fair value hierarchy. The cash flows are based on the directors' expectations of the expected physical apple yield, which are based on the entity's historical yield pattern by cultivar or by region over the estimated remaining fruit-bearing life of each tree, and the expected future prices of the cultivar of apples in the local market (where the entity sells its apples), which are based on current prices adjusted for inflation.

The cash flows also take into account all of the expected costs associated with maintaining the trees and harvesting the apples. A notional rental charge for land has been included in the calculation to reflect the cost of the land where the orchard is situated. To account for the risks specific to the entity's mature apple trees, a 10% risk adjustment factor is added to the risk-free interest rate in arriving at the discount rate used to measure the present value of the expected net cash flows.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* Accounting Standard to transactions or other events often requires an entity to use its judgement. Information about significant judgements made by an entity's management and key sources of estimation uncertainty are useful to a user of financial statements assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6 of the Standard, an entity discloses the judgements management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, in accordance with paragraph 8.7, an entity discloses information about the key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the Standard require disclosure of information about particular judgements and estimation uncertainties.

Fair value measurement

Areas that may require significant judgement when measuring assets and liabilities at fair value include:

- choosing and applying valuation techniques.
- identifying assets or liabilities that are similar to the asset or liability being measured for Level 2 fair value measurements.
- determining unobservable inputs for Level 3 fair value measurements.
- assessing whether the market qualifies as active, if a market for an asset does not have frequent or orderly transactions.
- determining the point in the range of values indicated by those results that is most representative of fair value, if multiple valuation techniques are used to measure fair value. For example, an SME might judge it appropriate to provide more weight to one valuation technique than another rather than calculating a simple average based on the outcomes of the various valuation techniques.

Often the inputs to the valuation model and other assumptions used when applying the model are subjective. For example, judgements in order to determine the fair value of investment property, depending on the valuation technique used and inputs to the valuation technique, might include:

- estimating future rental income, occupancy/vacancy rates, rent-free periods and discount rates;
- estimating property yields for similar properties in similar locations;
- assessing how similar other properties are and adjusting for any differences in the properties, their location and the timing and frequency of previous transactions; and
- assessing the structural condition of the properties.

When recent market transaction prices or market comparables are used to measure fair value, judgement may be required to:

- identify the most recent market transaction price for a similar asset and to evaluate whether economic circumstances have changed significantly since that transaction;
- identify suitable market comparables (for example, price/earnings ratios of similar companies); or
- estimate appropriate adjustments to those prices or comparables to reflect differences between the characteristics of the assets.

When the present value of expected net cash flows from the asset is used, estimation of the expected future net cash inflows and the current market-determined discount rate may require significant judgement and estimation. For example, judgement and estimates would be necessary when measuring fair value based on discounted cash flows for a forest grown for timber (biological assets) for the following items:

- plans for harvesting the growing timber (perhaps based on previous harvest timings and volumes);
- expected timber prices (based on local markets);
- expected costs of planting, managing and caring for the forest (based on historic costs weighted for inflation and current volumes, as well as any changes in composition and planting plans);
- growth rates; and
- discount rates.

SMEs making complex fair value measurements with many inputs might need to perform sensitivity analyses to evaluate which of the inputs have or could have significant effects on the fair value measurement. There will sometimes be interplay between inputs, for example, in a forest valuation, knowledge of expected timber prices might affect the volume of timber harvested (if prices are expected to increase in future). Price knowledge could also influence how the forest will be managed in the future (for example, planning different planting or delayed or accelerated harvesting). An SME might conclude that some factors are not significant because compensatory changes would be made if these factors changed.

Deciding whether the fair value of a particular investment can be measured reliably (or can be measured reliably without undue cost or effort) using a valuation model also usually involves judgement.

Fair value disclosures

An entity must use judgement to determine whether each input is significant to the entire measurement in order to categorise the fair value measurement at the level of the lowest level input (paragraph 12.22). Section 12 does not include specific thresholds for assessing when an input is significant—an entity needs to apply its judgement.

Determining the appropriate classes of assets and liabilities for applying the disclosure requirements may require judgement (paragraph 12.30). A class of assets and liabilities will often require disaggregation for the disclosures in Section 12 beyond the line items presented in the statement of financial position.

TRANSITION REQUIREMENTS

The third edition of the *IFRS for SMEs* Accounting Standard (Standard) is effective for annual reporting periods beginning on or after 1 January 2027. Early application is permitted. Changes made by the new Section 12 to the second edition of the Standard are summarised on page 8.

Paragraphs A12–A14 of the third edition of the Standard set out the transition requirements for the fair value measurement requirements in Section 12.

A12	An entity shall prospectively apply the new Section 12 *Fair Value Measurement* and paragraph 2.89 from the date of initial application.
A13	An entity is not required to apply the disclosure requirements in the new Section 12 to comparative information provided for periods before the date of initial application.
A14	The new Section 12 amended paragraphs 11.14(c), 11.43, 11.57, 13.3(a), 14.10, 14.15, 15.15, 15.21, 16.7, 17.15B, 27.9(c), 27.14, 28.15(b), 34.4 and 34.6; deleted paragraphs 11.27–11.32, 12.12, 16.10(a), 17.33(c) and 34.7(b); and added paragraphs 26.1D–26.1E. An entity shall also prospectively apply those amendments from the date of initial application.

Educational notes

An entity shall prospectively apply the new Section 12 from the date of initial application, that is, from the beginning of the reporting period in which an entity first applies the third edition of the Standard.

Therefore, an entity is not required to restate fair value measurements in comparative periods or apply the disclosure requirements in the new Section 12 to comparative information provided for periods before the date of initial application.

For example, if an entity has a 31 December closing date and applies the third edition of the Standard to its annual reporting period ending on 31 December 2027:

- the entity's initial date of application is 1 January 2027;
- the entity applies Section 12 to fair value measurements in 2027 and applies the disclosure requirements in Section 12 to its financial information for the year ended 31 December 2027; and
- the entity does not restate the 2026 comparative information for Section 12, nor apply the disclosure requirements in Section 12 for the 2026 comparative information.

The new Section 12 resulted in amendments to paragraphs in several other sections of the Standard (see paragraph A14 of the Standard) because these other sections require fair value measurements. Following the introduction of Section 12 in the third edition of the Standard, these fair value measurements will be made applying Section 12.

COMPARISON WITH FULL IFRS ACCOUNTING STANDARDS

The requirements in full IFRS Accounting Standards (see IFRS 13 *Fair Value Measurement*) and those in the *IFRS for SMEs* Accounting Standard (see Section 12 *Fair Value Measurement*) vary as at February 2025. The main differences are that:

- IFRS 13 includes specific fair value measurement guidance on liabilities and own equity instruments, including guidance on non-performance risk. IFRS 13 also includes specific fair value measurement guidance for financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk. Section 12 does not have similar guidance as such guidance is unlikely to be relevant to many SMEs.
- Section 12 is drafted in simpler language than that used in IFRS 13.

This table sets out the disclosures in IFRS 13 compared with the disclosures in Section 12. 'X' means a disclosure requirement has no equivalent:

IFRS 13 paragraph	Section 12 paragraph
91	X
92	X
93(a)	12.28(a)
93(b)	12.28(b)
93(c)	12.28(c)
93(e)(i)–(ii)	12.29
93(c), (e)(iii)–(iv), (f), (g), (h) and (i)	X
94	12.30, 12.31
95	X
96	X
97	X
98	X
99	12.32

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements in Section 12 *Fair Value Measurement* of the *IFRS for SMEs* Accounting Standard by answering the questions provided.

Assume all amounts mentioned are material.

Once you have completed the test, check your answers against those supplied on page 55.

Mark the box next to the most correct statement.

Question 1

Which of the following fair value measurements is outside the scope of Section 12?

- ☐ (a) Investment property measured at fair value applying Section 16.
- ☐ (b) Share-based payment transactions measured at fair value applying Section 26.
- ☐ (c) Biological assets measured at fair value less costs to sell applying Section 34.
- ☐ (d) None of the above.

Question 2

Which of the following statements is true when measuring the fair value of an asset applying Section 12?

- ☐ (a) An entity shall use the same assumptions that market participants would use when pricing the asset.
- ☐ (b) An entity shall consider its own intention regarding whether to hold or sell the asset.
- ☐ (c) An entity shall consider that a forced or distress sale takes place if no quoted price is available.
- ☐ (d) None of the above.

Question 3

Which of the following is not a characteristic of market participants in the principal (or most advantageous) market for the asset or liability for the purposes of Section 12?

- ☐ (a) They are independent of each other—that is, they are not related parties as defined in Section 33.
- ☐ (b) They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information.
- ☐ (c) They have formally agreed to enter into a transaction for the asset or liability.
- ☐ (d) They are not forced to enter into a transaction for the asset or liability.

Question 4

Which of the following is a characteristic that should be considered in measuring a property's fair value applying Section 12?

- ☐ (a) Commission fees that would be incurred on disposal of the property.
- ☐ (b) An agreement between the owner of the property and a bank that identifies the property as security for the loan and prevents the owner from selling the property during the term of the loan.
- ☐ (c) An agreement that no development can be made for 10 years on a part of the property that is used as a nature reserve.
- ☐ (d) All of the above.

Question 5

An SME owns a piece of land that has been used for storing chemical waste. The land cannot be legally sold until it has been remediated. Which of the following characteristics should be taken into account when measuring the fair value of the land at the measurement date?

- ☐ (a) The land is contaminated by chemical waste.
- ☐ (b) The land cannot be sold until it has been remediated.
- ☐ (c) Neither (a) or (b).
- ☐ (d) Both (a) and (b).

Question 6

An SME acquires a research and development (R&D) project in a business combination. The entity does not intend to complete the project. If completed, the project would compete with one of its own projects to provide the next generation of the entity's commercialised technology. Instead, the entity intends to stop development on (that is, lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology. However, from the perspective of market participants the project is expected to be loss-making if continued and would not provide any defensive value.

What is the highest and best use of the R&D project for the purposes of Section 12 and why?

- ☐ (a) The highest and best use of the R&D project would be to continue development because market participants would continue to develop the project to maximise the value of the group of assets in which the project would be used.
- ☐ (b) The highest and best use of the R&D project would be to cease development because the SME intends to lock up the project to prevent competitors from obtaining access to the technology.
- ☐ (c) The highest and best use of the R&D project would be to cease development because the market participants would lock up the project to prevent competitors from obtaining access to the technology.
- ☐ (d) The highest and best use of the R&D project would be to cease development because market participants would cease development to maximise the value of the group of assets in which the project would be used.

Question 7

An SME measures the fair value of its investment property using recent transactions of similar properties. Such a valuation technique is consistent with which of the following approaches?

- ☐ (a) Market approach.
- ☐ (b) Income approach.
- ☐ (c) Cost approach.
- ☐ (d) None of the above.

Question 8

How should an SME account for revisions resulting from a change in valuation technique, applying Section 10 of the Standard?

- ☐ (a) As a change in accounting estimate. The disclosure requirements for a change in accounting estimate in Section 10 are also required.
- ☐ (b) As a change in accounting estimate. However, the disclosure requirements for a change in accounting estimate in Section 10 are not required.
- ☐ (c) As a change in accounting policy. The disclosure requirements for a change in accounting policy in Section 10 are also required.
- ☐ (d) As a change in accounting policy. However, the disclosure requirements for a change in accounting policy in Section 10 are not required.

Question 9

An SME holds quoted shares in a company traded on a major stock exchange. At what level of the fair value hierarchy would the measurement be categorised?

- ☐ (a) Level 1.
- ☐ (b) Level 2.
- ☐ (c) Level 3.

Question 10

An SME holds shares in an unquoted company. The fair value measurement uses earnings multiples from similar listed competitors along with various unobservable inputs. At what level of the fair value hierarchy would the measurement be categorised?

- ☐ (a) Level 1.
- ☐ (b) Level 2.
- ☐ (c) Level 3.

Answers

Q1 (b)—see paragraph 12.1.

Q2 (a)—see paragraphs 12.3 and 12.4.

Q3 (c)—see paragraph 12.4 and definition of market participants.

Q4 (c)—see paragraphs 12.5 and 12.8.

Q5 (d)—see paragraph 12.5.

Q6 (d)—see paragraph 12.10. The project is expected to be loss-making if continued and would not provide any defensive value.

Q7 (a)—see paragraph 12.15.

Q8 (b)—see paragraph 12.16.

Q9 (a)—see paragraphs 12.22 and 12.23.

Q10 (c)—see paragraphs 12.22 and 12.27.

APPLY YOUR KNOWLEDGE

You can apply your knowledge of the requirements in Section 12 of the *IFRS for SMEs* Accounting Standard by completing the case studies provided.

Once you have completed a case study, check your answers against those on page 57 for Case study 1 and pages 59–60 for Case study 2.

Case study 1

An SME, located in Argentina, grows and distributes oranges. The SME usually sells oranges in the Argentinian market, and on occasion it also sells oranges in the Brazilian market. The SME does not have access to the Indian market.

Net proceeds that would be received by the SME from transactions in three markets (amounts in CU):

	Argentina	Brazil	India
Observable market price (gross proceeds)	12	15	10
Transaction costs in the market	2	3	1
Transportation costs to get the oranges to the market	5	9	2
Net amount received	5	3	7

Part A—Assume that the Brazilian market is the market with the greatest volume and level of activity for oranges worldwide. Determine the appropriate price to use to measure the fair value of the oranges.

Part B—Assume that there is no principal market for the oranges. Determine the appropriate price to use to measure the fair value of the oranges.

Answer to Case study 1—Part A

If there is a principal market for the asset or liability, paragraph 12.6 requires the price in that market to be used, even if the price in a different market is potentially more advantageous at the measurement date.

The Brazilian market is the principal market for the oranges (that is, the market with the greatest volume and level of activity for oranges worldwide).

Paragraph 12.7 states that an entity must have access to the principal market at the measurement date.

The SME has access to the Brazilian orange market. Therefore, the SME shall assume that the transaction to sell the oranges takes place in the Brazilian market.

The fair value of the oranges would be measured using the price in the Brazilian market of CU6 per orange = market price (CU15) – transport costs (CU9). Transaction costs are ignored when measuring the fair value of the oranges (see paragraph 12.8).

Answer to Case study 1—Part B

If no market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market.

The most advantageous market is the market that maximises the amount that would be received to sell the asset after taking into account transaction costs and transport costs—that is, comparing the net amount that would be received in the respective markets.

The market that maximises the net amount that would be received is the Indian market.

Paragraph 12.7 states that an entity must have access to the most advantageous market at the measurement date. Although, the net amount received would be highest in the Indian market, the SME does not have access to the Indian market.

Therefore, the SME assesses whether the Brazilian market or the Argentinian market is the most advantageous market.

The net amount that would be received in the Argentinian market is CU5, which is greater than the net amount of CU3 that would be received in the Brazilian market. Therefore, the Argentinian market is the most advantageous market.

The fair value of the oranges would be measured using the price in the Argentinian market of CU7 per orange = market price (CU12) – transport costs (CU5).

Note that transaction costs are considered in determining the most advantageous market (see the definition of ‘most advantageous market’ in the Glossary). However, they are not deducted in the fair value measurement (see paragraph 12.8).

Case study 2

An SME determines the fair value of a customised machine that is held and used in its operations. The SME determines that the asset would provide maximum value to market participants through its use in combination with other assets (as installed and configured for use). There is no evidence to suggest that the current use of the machine is not its highest and best use.

The SME determines that the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows.

Part A—When might an SME be required to measure the fair value of the customised machine applying the *IFRS for SMEs* Accounting Standard?

Part B—Describe some of the considerations that an SME might make when selecting a valuation technique for the customised machine under the three approaches in paragraph 12.15 of the Standard (market approach, cost approach and income approach).

Answer to Case study 2—Part A

The main situations in which an SME could be required to measure the fair value of a customised machine applying the *IFRS for SMEs* Accounting Standard arise when:

- the customised machine is in a class of property, plant and equipment measured after initial recognition at a revalued amount that is its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses (Section 17 *Property, Plant and Equipment*).
- the SME acquires the machine in a business combination—because the machine would be part of the identifiable assets and liabilities of an acquiree measured at fair value at the acquisition date (Section 19 *Business Combinations and Goodwill*).
- there is an indication that the customised machine is impaired. In this case, an SME might need to measure the fair value less costs of disposal of the customised machine to determine the recoverable amount under Section 27 *Impairment of Assets*. However, given that the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows, Section 27 might require the recoverable amount to be determined for the cash-generating unit to which the machine belongs, rather than the individual machine.
- the customised machine is distributed to owners of the SME (Section 22 *Liabilities and Equity*).

Answer to Case study 2—Part B

The highest and best use of the machine is its current use in combination with other assets. When deciding which of the three valuation approaches to use in paragraph 12.15, the SME might consider the following options:

- a market approach might be applied, for example, using quoted prices adjusted for differences between the machine (as customised) and similar uncustomised machines. The measurement would need to reflect the price that would be received for the machine in its current condition (used) and location (installed and configured for use). If the customisation of the machine is not significant, the inputs used in the market approach (quoted prices for similar machines) might require fewer and less subjective adjustments than the inputs used in the cost approach or income approach.
- a cost approach might be applied by estimating the amount that would be required currently to construct a substitute (customised) machine of comparable utility. The estimate would consider, for example, the condition of the machine and the environment in which it operates, including physical wear and tear (physical deterioration), obsolescence (such as improvements in technology) and installation costs. If the customisation of the machine is extensive or if there is insufficient data available to apply the market approach (for example, because market data reflects transactions for machines used on a stand-alone basis rather than machines used in combination with other assets), the entity may need to apply the cost approach. When an asset is used in combination with other assets, the cost approach assumes the sale of the machine to a market participant buyer with access to the complementary assets. The price received for the sale of the machines (the exit price) would not be more than the higher of:
  - the cost that a market participant buyer would incur to acquire or construct a substitute machine of comparable utility; or
  - the economic benefit that a market participant buyer would derive from use of the machine.
- an income approach might not be appropriate because the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows. However, if there is information about short-term and intermediate-term lease rates for similar used machinery, and if leasing out the asset could be its highest and best use, that information might be used to project an income stream (lease payments over the remaining service life).

NOTES

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