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# SL-25-1 – Advanced Corporate Reporting

## Strategic Level (2025 Curriculum)

- SLFRS 13 – Fair Value Measurement



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## SLFRS 13 Fair Value Measurement

SLFRS 13 Fair value measurement provides guidance on determining fair value where other standards require an item to be measured at fair value.

Can be applied to:

- LKAS 16 Property, plant and equipment
- LKAS 40 Investment property
- LKAS 41 Agriculture
- SLFRS 09 Financial instruments

SLFRS 13 does not, however, apply to the measurement of fair value in respect of the following:

- A) Share-based payment transactions within the scope of SLFRS 2 Share-based payment,
- B) Leasing transactions within the scope of LKAS 17 Leases; and
- C) Net realizable value as in LKAS 2 Inventories; or value in use as in LKAS 36 Impairment of assets.

In each of these cases, the relevant standard provides the required guidance.

### Definition of Fair Value

Fair value is defined as:

***'The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.'***

This is an exit price, ie the price that an entity disposing of an asset or liability would achieve rather than the price that an entity acquiring an asset or liability would have to pay.

### Measurement

Fair value is a market-based measurement, **not an entity-specific measurement**. Therefore, fair value is measured using the assumptions that market participants would use when pricing the asset under current market conditions, taking into account any relevant characteristics of the asset.

Therefore, whether an entity intends to hold an asset or settle a liability is irrelevant when measuring fair value.

A fair value measurement requires an entity to determine:

- A) The item being measured.
- B) For a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets.
- C) The market in which an orderly transaction would take place for the asset or liability.
- D) The appropriate valuation technique to use when measuring fair value.

### **The item being measured (The asset or liability)**

A fair value measurement is for a particular asset or a liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include:

- A) the condition and location of the asset; and
- B) restrictions, if any, on the sale or use of the asset.

The item for which fair value is determined is referred to in SLFRS 13 as the **'unit of account'**. It is defined as the level at which an asset or liability is aggregated or disaggregated in an SLFRS for accounting purposes. The unit of account can be either of following.

- A) a standalone asset or liability (e.g., a financial instrument or a non-financial asset); or
- B) a group of assets, a group of liabilities or a group of assets and liabilities (e.g., a cash generating unit or a business).

### **Example: Unit of Account**

A premium or discount on a large holding of the same shares (because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) is not considered when measuring fair value: the quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.

## **Application to non-financial assets**

### **Highest and best use**

In the case of non-financial assets, fair value is determined based on the highest and best use of the asset from the **perspective of a market participant** (not the entity's perspective).

The highest and best use should be:

- **Physically possible** - Physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property)
- **Legally permissible** - Legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property)
- **Financially feasible** - whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

In many cases, it can be assumed that the current use of an asset is its highest and best use.

#### **Example: highest and best use**

An entity acquires land that is currently developed for industrial use as a site for a factory. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that evidence, the entity believes that the land could be developed for residential use.

The fair value of the land based on highest and best use is therefore the higher of:

- The value of the land as currently developed for industrial use, or
- The value of the land as a vacant site for residential use taking into account the costs of demolishing the factory and other costs to convert the land to a vacant site.

#### **The market**

It is assumed that the transaction to sell an asset or transfer a liability takes place either:

- A) In the **principal market** for the asset or liability, or
- B) In the absence of a principal market, in the **most advantageous market** for the asset or liability.

The principal market is the market with the greatest volume and level of activity for that asset or liability. If a principal market exists, then the price in that market must be used to establish fair value.

The most advantageous market is the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to

transfer the liability after taking into account transaction and transport costs. Although transaction costs are taken into account when determining the most advantageous market, fair value once determined is not adjusted for these costs.

- A) In most cases, the principal market and the most advantageous market will be the same.
- B) It is presumed that the market in which an entity normally transacts is the principal or most advantageous market, unless there is evidence to the contrary.

It is important to note that although an entity must be able to access the market, the entity does not need to be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value on the basis of the price in that market.

## The Price

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

Points to note in determining the price.

- In determining the price **Transaction Costs** shall not be adjusted.
  - Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.
- In determining the price **Transport Costs** shall be considered.
  - If location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

### Question 01

You work in the accounting department at Mannar Machines Ltd. As you have recently studied SLFRS 13, the financial controller has asked you to review her

workings to establish the fair value of inventory held by a subsidiary that Mannar Machines has recently acquired:

### Production Line 1 (100,000 units)

|                                    | Asia    | Europe  | Africa |
|------------------------------------|---------|---------|--------|
| Sales volume in previous 12 months | 240,300 | 180,300 | 90,200 |
|                                    | Rs.     | Rs.     | Rs.    |
| Selling price per unit             | 350     | 390     | 325    |
| Transaction costs                  | 10      | 20      | 15     |
| Transport to market costs          | 5       | 30      | 20     |
| Net price received                 | 335     | 340     | 290    |

### Production Line 2 (500 units)

|                                    | Asia   | Europe | Africa |
|------------------------------------|--------|--------|--------|
| Sales volume in previous 12 months | 10,000 | -      | 10,000 |
|                                    | Rs.    | Rs.    | Rs.    |
| Selling price per unit             | 2,300  | -      | 2,450  |
| Transaction costs                  | 100    | -      | 120    |
| Transport to market costs          | 60     | -      | 90     |
| Net price received                 | 2,140  | -      | 2,240  |

### Therefore:

|                                   | Rs.        |
|-----------------------------------|------------|
| Product line 1: 100,000 x Rs. 340 | 34,000,000 |
| Product line 2: 500 x Rs. 2,240   | 1,120,000  |
| Fair value of inventory acquired  | 35,120,000 |

### Required:

1. **Prepare** notes explaining how the fair value of the above inventory acquired should be determined in accordance with SLFRS 13.

### Valuation Techniques

SLFRS 13 does not require the use of a particular valuation technique, however it does require a technique that is 'appropriate in the circumstances' and that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs.

The standard discusses three widely used valuation techniques:

| The market approach                        | The cost approach                              | The income approach                        |
|--------------------------------------------|------------------------------------------------|--------------------------------------------|
| A valuation technique that uses prices and | A valuation technique that reflects the amount | A valuation technique that converts future |

|                                                                                                                                                         |                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                             |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| other relevant information generated by market transactions involving identical or comparable assets and liabilities.<br><br>Ex: Using market multiples | that would be required currently to replace the service capacity of an asset. (Referred to as current replacement cost)<br><br>This method is mostly used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities. | amounts (e.g., cash flows or income) to a single discounted amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts. |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

Whichever valuation technique is selected, it should be applied consistently from period to period. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate in accordance with LKAS 8.

#### Question 02 - ACCA

Baklava has an investment property that is measured at fair value. This property is rented out on short-term leases.

The directors wish to fair value the property by estimating the present value of the net cash flows that the property will generate for Baklava. They argue that this best reflects the way in which the building will generate economic benefits for Baklava.

The building is unique, although there have been many sales of similar buildings in the local area.

#### Required:

Discuss whether the valuation technique suggested by the directors complies with International Financial Reporting Standards.

#### Inputs to Valuation Techniques

The standard requires that in any valuation technique, the use of relevant observable inputs should be maximized, and unobservable inputs minimized. To increase consistency and comparability in fair value measurements and related disclosures, SLFRS 13 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value.

The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

|                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|----------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Level 1</b> | <ul style="list-style-type: none"> <li>Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.</li> <li>Provides most reliable evidence.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| <b>Level 2</b> | <ul style="list-style-type: none"> <li>Inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.</li> <li>If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability.</li> <li>Examples, <ul style="list-style-type: none"> <li>Quoted prices for similar assets or liabilities in active markets</li> <li>Quoted prices for identical or similar assets or liabilities in markets that are not active</li> <li>Inputs other than quoted prices that are observable <ul style="list-style-type: none"> <li>Interest rates and yield curves</li> <li>Credit spreads</li> </ul> </li> </ul> </li> </ul> |
| <b>Level 3</b> | <ul style="list-style-type: none"> <li>Inputs are unobservable inputs for the asset or liability.</li> <li>Shall be used to measure fair value to the extent that relevant observable inputs are not available.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |

**Note** following.

- The fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques used to measure fair value.
  - For example, a fair value measurement developed using a present value technique might be categorized within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorized.
- 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 categorized within Level 3 of the fair value hierarchy.

An item's fair value is categorized according to the lowest level input. Therefore, a fair value measurement of quoted shares based on the unadjusted share price is a Level 1 measurement, whereas a fair value measurement of an unquoted

investment using a valuation technique based on discounted cash flows is a Level 3 measurement.

### **Example of inputs**

|         | <b>Asset</b>                     | <b>Example</b>                                                                                                                                 |
|---------|----------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------|
| Level 1 | Equity shares in a listed entity | Unadjusted quoted prices in an active market                                                                                                   |
| Level 2 | Building held and used           | Price per square meter for the building from observable market data, such as observed transactions for similar buildings in similar locations. |
| Level 3 | Cash-generating unit             | Profit or cash flow forecast using own data                                                                                                    |

## **Measurement of Financial Instruments**

### **Financial Assets**

The following should be considered where a financial asset is being fair valued.

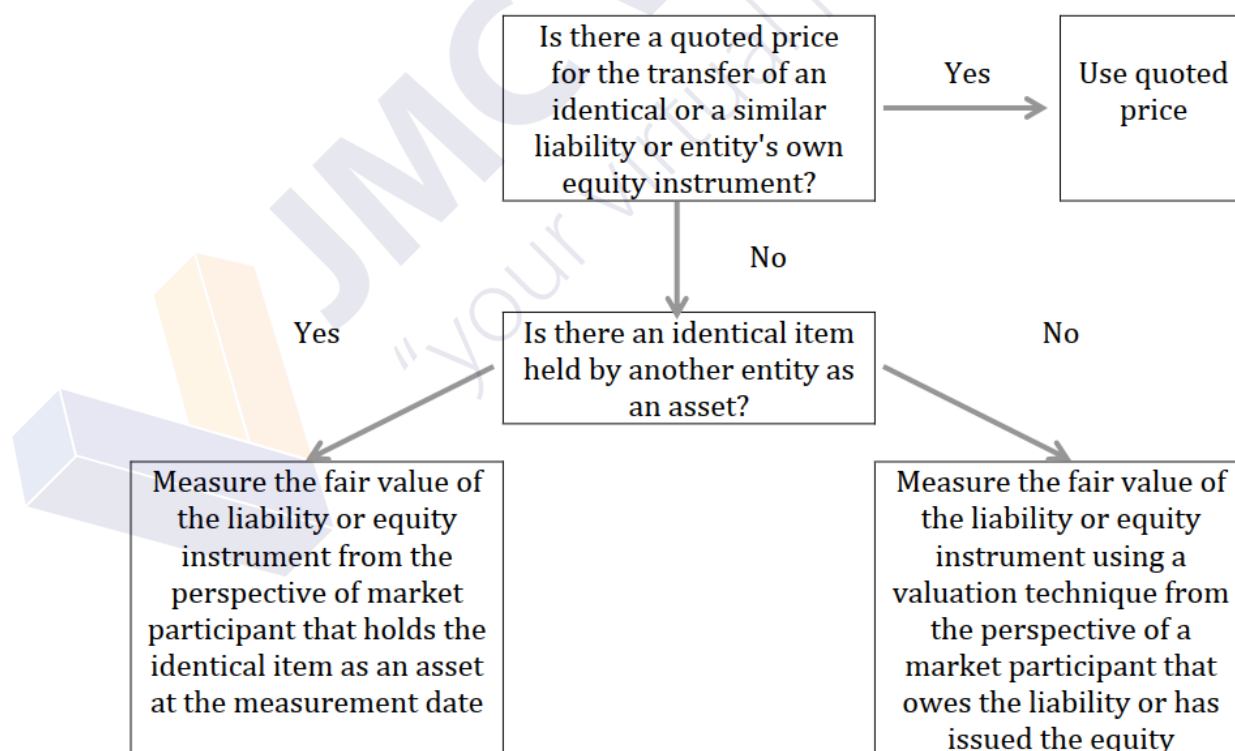
- A) If a quoted item has a bid price (the price that buyers are willing to pay) and an ask price (the price that sellers are willing to achieve), the price within the bid-ask spread that is most representative of fair value is used to measure fair value. The use of bid prices for financial assets and the use of ask prices for financial liabilities is permitted but not required. SLFRS 13 does not preclude the use of mid-market pricing.
- B) In the case of equity shares, a control premium is considered when measuring the fair value of a controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.
- C) The valuation of unlisted equity investments involves significant judgement, and different valuation techniques are likely to result in different fair values, however this does not mean that any of the techniques are incorrect. Certain techniques are better suited to particular types of business, for example an asset-based approach is relevant to property companies while an income approach is more relevant to service businesses. It is likely that valuation will be based on some unobservable inputs and as a result the overall fair value will be classified as a Level 3 measurement.

## **Liabilities and Own Equity Instruments**

Liabilities and own equity instruments (e.g. equity interests issued as consideration in a business combination) must be measured on the assumption that the liability or equity is transferred to a market participant at the measurement date and therefore:

- A) A liability would remain outstanding, and the market participant would be required to fulfil the obligation.
- B) An entity's own equity instrument would remain outstanding, and the market participant would take on the rights and responsibilities associated with the instrument. This differs (sometimes significantly so) from a measurement that is based on the assumption of settlement of a liability or cancellation of an entity's own equity instrument.

SLFRS 13 further requires that the fair value of a liability must factor in nonperformance risk. Anything that could influence the likelihood of an obligation being fulfilled is considered a non-performance risk. This could include the risk of physically extracting or transporting an asset or the entity's own credit risk. The specific approach to fair value liabilities and an entity's own equity instruments sometimes differs from the concepts to fair value an asset and is summarized in the following flowchart.



## Disclosure

An entity should disclose information that helps users of the financial statements assess both of the following.

- A) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.
- B) For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

### Question 03

ABC Ltd acquired a property by way of a finance lease in the year ended 31 December 20X3. It sublets the property to small businesses. The lease stipulates that the property must be used for commercial rather than residential purposes. This restriction is not imposed by the planning authorities and therefore at a future date the property could be used for residential purposes. The owner has established that were the property to be sold at 31 December 20X3, it would raise Rs. 29 million if sold as a residential apartment block, or Rs. 25 million if sold as offices. In either case, legal fees of 1% of the sale price would be incurred.

#### Required:

- (a) Explain how the fair value of the property is determined.

### Question 04

Sitka Co is a software development company which operates in an industry where technologies change rapidly. Its customers use the cloud to access the software and Sitka Co generates revenue by charging customers for the software license and software updates. It has recently disposed of an interest in a subsidiary, Marlett Co, and purchased a controlling interest in Billing Co. The year end of the company is 31 December 20X7.

#### Acquisition of Billing Co

Sitka Co has acquired two assets in a business combination with Billing Co. The first asset is 'Qbooks' which is an accounting system developed by Billing Co for use with the second asset which is 'Best Cloud' software. The directors of Sitka Co believe that the fair value of the assets is higher if valued together rather than

individually. If the assets were to be sold, there are two types of buyers that would be interested in purchasing the assets. One buyer group would be those who operate in the same industry and have similar assets. This group of buyers would eventually replace Qbooks with their own accounting system which would enhance the value of their assets. The fair values of the individual assets in the industry buyer group would be \$30 million for Qbooks and \$200 million for 'Best Cloud', therefore being \$230 million in total. Another type of buyer is the financial investor who would not have a substitute asset for Qbooks. They would licence Qbooks for its remaining life and commercialise the product. The indicated fair values for Qbooks and Best Cloud within the financial investor group are \$50million and \$150 million, being \$200 million in total.

### Required:

Discuss how the two assets acquired on the acquisition of Billing Co should be valued in accordance SLFRS 13 Fair Value Measurement.

### Question 05

Yellow owns several farms and owns a division which sells agricultural vehicles. It is considering selling this agricultural retail division and wishes to measure the fair value of the inventory of vehicles for the purpose of the sale. Three markets currently exist for the vehicles. Yellow has transacted regularly in all three markets. At 30 April 2015, Yellow wishes to find the fair value of 150 new vehicles, which are identical. The current volume and prices in the three markets are as follows:

| Market | Sales Price per vehicle (USD) | Historical Volume (No of vehicles sold by yellow) | Total volume of vehicles sold in the market | Transaction cost per vehicle (USD) | Transport cost to the market per vehicle (USD) |
|--------|-------------------------------|---------------------------------------------------|---------------------------------------------|------------------------------------|------------------------------------------------|
| Europe | 40,000                        | 6,000                                             | 150,000                                     | 500                                | 400                                            |
| Asia   | 38,000                        | 2,500                                             | 750,000                                     | 400                                | 700                                            |
| Africa | 34,000                        | 1,500                                             | 100,000                                     | 300                                | 600                                            |

Yellow wishes to value the vehicles at \$39,100 per vehicle as these are the highest net proceeds per vehicle, and Europe is the largest market for Yellow product.

### Required:

1. Comment on the method used by Yellow in measuring the fair value of Agricultural Vehicles