

ACC/ACF3100 Week 4 Tutorial Solutions
Fair Value Measurement

Henderson et al. Chapter 4

Questions

2. Explain why fair value measurements are a controversial topic in financial reporting.

Fair value measurement is a controversial topic for several reasons including:

- In the **absence of an active market** for an asset or liability, fair value measurements may be perceived as being unreliable;
- Fair value measurements may be viewed as **irrelevant if their use** is perceived to conflict with the ‘business model’ associated with an asset or liability. For example, some managers consider that where a financial asset is being held for the purpose of collecting its contractual cash flows, the current fair value of that financial asset does not have anything to do with the economic consequences that will flow from holding that financial asset;
- The fair values of many items are volatile and are often **outside the control of management**. Allowing these volatile fair value measures to impact on reported profits will be unfair to managers whose remuneration is tied to reported profits. That is, managers will be impacted by factors they can’t control and so their performance will not be appropriately reported; and
- The **volatility** of fair value measures may reduce their relevance for use in debt contracts because the fair value movements may not reflect the actual contractual cash flows associated with debt instruments.

3. Why would accounting standard setters persist in advocating the use of fair value measurements in standards when many of their constituents object to such measurements?

The IASB, FASB and other accounting standards-setters have persisted with advocating the use of fair value measurement, notwithstanding significant lobbying efforts from some of their constituents who wished to see the use of fair value wound back (especially during the GFC). The article by Power (2010) provides a number of explanations for the rise of fair value accounting.

It should be remembered that standard-setters have not adopted fair value measures across all standards, nor across all assets and liabilities. Two arguments may be made in this regard:

- Standard-setters have adopted fair value measures in those circumstances where they believe those measures will promote relevant, decision-useful information for financial statement users. For example, the fair value of financial assets in the context of financial institutions (e.g., banks, insurance entities) is likely to be more relevant than the historical costs of those financial assets, because financial statement users want information about the ability of those entities to make payments (e.g., can depositors in banks get their funds when required; can an insurance entity pay claims when needed; etc.).
- Since the use of historical cost is still common, IFRS represents a conservative approach to accounting. According to Barker and McGeachin (2015), “there is inconsistency between IFRS at a conceptual level and IFRS in practice in accounting standards themselves” (p. 202).

11. What is the difference between the principal market and the most advantageous market? What is the role of these concepts in AASB 13?

Under *AASB 13*, management **assumes** that the transaction to sell the asset or transfer the liability takes place in the **principal market** or, in the absence of a principal market, **the most advantageous market** (para. 16).

The principal market is the market with the greatest volume and level of activity for the asset or liability (Appendix A). In the absence of evidence to the contrary, the market in which an entity would normally enter into a transaction to sell an asset or transfer a liability is presumed to be the principal market or the most advantageous market in the absence of a principal market (para. 17).

The most advantageous market is the market that maximises the amount that would be received to sell the asset, or that minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs (Appendix A). The entity must have access to the principal or most advantageous market at the measurement date.

As different reporting entities may have access to different markets, the principal or most advantageous market could vary between reporting entities (para. 19). Although an entity must be able to access the market, it 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 (para. 20).

AASB 13 prohibits the adjustment of fair value for transaction costs. However, it does require such transaction costs to be considered in determining the most advantageous market.

13. Explain the difference between observable inputs and unobservable inputs for use in valuation techniques. Why does AASB 13 require that entities maximise the use of observable inputs?

Observable and unobservable inputs are information that is used to generate fair value measures. Appendix A of *AASB 13* defines observable and unobservable inputs as follows:

Observable Inputs

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

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.

An example of an observable input is the quoted price of a listed company's shares while an example of an unobservable input would be management's estimate of the future cash flows associated with a piece of equipment. Observable inputs are preferred to unobservable inputs because the former are likely to be more **independent and not subject to any managerial bias** and will reflect market participants' assessments rather than entity specific circumstances.

14. Describe three common valuation techniques that are used to measure the fair value of assets and liabilities.

Paragraph 62 of AASB 13 identifies three widely used valuation techniques. They are:

- the *market approach*, which uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities – for example, the use of option pricing models;
- the *income approach*, which converts future amounts to a present value – for example, the use of discounted cash flow methods; and
- the *cost approach*, which uses the current replacement cost of the asset. This assumes that fair value is the cost to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence (paras B5–B11).

15. What is the ‘fair value hierarchy’, and what is its role in the measurement of fair value?

The ‘fair value hierarchy’ is a ranking of the desirability of the inputs to valuation techniques for use in measuring fair value. The hierarchy categorises the various inputs into three different levels (para. 73). The role of the hierarchy is to ensure that fair value measures maximise the use of relevant observable inputs and that the use of unobservable inputs is minimised, as required by paragraph 67.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that management can access at the measurement date (para. 76).

Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly (para. 81). Level 2 inputs include:

- quoted prices for similar assets or liabilities in active markets;
- quoted prices for identical or similar assets or liabilities in markets that are not active;
- inputs other than quoted prices that are observable for the asset or liability – for example, interest rates and yield curves observable at commonly quoted intervals; and
- market-corroborated inputs. (para. 82)

Level 3 inputs are unobservable inputs for the asset or liability (para. 86). This might include future net cash flows that are used to value a business or non-controlling interest in an entity that is not publicly listed. Although fair value measurements based on Level 3 inputs do not use any relevant observable inputs, in making these measurements the entity’s management must still adhere to the objective of AASB 13 – that is, the fair value measure should still reflect the assumptions that market participants would use when pricing the asset or the liability (para. 87).

Level 1 inputs are the most preferred inputs to valuation techniques, followed by Level 2 inputs and, finally, Level 3 inputs. Where Level 1 inputs are available for measuring

the fair value of an asset or a liability, they must be used without any adjustments (para. 69).

Problem 1

As a principal market does not exist, the asset's fair value would be measured using the price in the **most advantageous market**. This is the market that maximises the amount that would be received by selling the asset after deducting transport costs and transaction costs.

In the case of Carter Ltd, the most advantageous market is Market East, where the net amount that would be received is \$23.50. As a result, the fair value of the asset is measured using the price in that market (\$27), less transport costs (\$2), resulting in a fair value of \$25. Note that although transaction costs are taken into account when deciding which market is the most advantageous, the price used to measure the fair value of the asset is not adjusted for those costs.

Problem 2

Under *AASB 13*, management assumes that the transaction to sell the asset or transfer the liability takes place in the principal market or, in the absence of a principal market, the most advantageous market (para. 16). The principal market is the market with the greatest volume and level of activity for the asset or liability (Appendix A). In the absence of evidence to the contrary, the market in which an entity would normally enter into a transaction to sell an asset or transfer a liability is presumed to be the principal market or the most advantageous market in the absence of a principal market (para. 17). The entity must have access to the principal or most advantageous market at the measurement date.

In the case of Lavocah Ltd, the principal market is Market A. Although Lavocah Ltd normally trades in Market C, it is Market A that has the greatest volume and level of activity for the asset. There is nothing in the facts that suggest that Lavocah Ltd could not access Market A, even though that is not its usual trading behaviour.

As a result, the fair value of the asset is measured using the price in that market (\$100), less transport costs (\$6), resulting in a fair value of \$94