

PROPOSED FINANCIAL REPORTING STANDARD	ED/FRS X
--	-----------------

**Draft Illustrative Examples
Exposure Draft**

Fair Value Measurement

Comments to be received 4 August 2009

CONTENTS

paragraphs

FAIR VALUE MEASUREMENT

[DRAFT] ILLUSTRATIVE EXAMPLES

HIGHEST AND BEST USE AND VALUATION PREMISE IE1–IE9

Example 1—Asset group IE2–IE4

Example 2—Land IE5–IE8

Example 3—Research and development project IE9

VALUATION TECHNIQUES IE10–IE17

Example 4—Machine held and used IE11–IE14

Example 5—Software asset IE15–IE17

FAIR VALUE HIERARCHY IE18–IE21

Example 6—Level 1 most advantageous market IE19–IE21

TRANSACTION PRICES AND FAIR VALUE AT INITIAL RECOGNITION IE22–IE23

Example 7—Interest rate swap at initial recognition IE23

RESTRICTED ASSETS IE24–IE26

Example 8—Restriction on the sale of an equity instrument IE25

Example 9—Restrictions on the use of an asset IE26

LIABILITIES AND CREDIT RISK IE27–IE28

Example 10—Structured note IE28

FAIR VALUE MEASUREMENTS IN MARKETS THAT ARE NOT ACTIVE IE29–IE38

Example 11—Inactive market IE30–IE38

FAIR VALUE DISCLOSURE IE39–IE41

Example 12—Assets measured at fair value IE40

Example 13—Fair value measurements in Level 3 of the fair value hierarchy IE41

APPENDIX

[Draft] Amendments to guidance on other FRSs

PROPOSED FINANCIAL REPORTING STANDARD

ED/FRS X

FRS X *Fair Value Measurement* [Draft] Illustrative examples

These [draft] examples accompany, but are not part of, [draft] FRS X

Highest and best use and valuation premise

- IE1 Examples 1–3 illustrate the application of the ‘highest and best use’ and valuation premise concepts when non-financial assets are newly acquired.

Example 1—Asset group

- IE2 An entity, a strategic buyer, acquires a group of assets (Assets A, B and C) in a business combination. Asset C is billing software developed by the acquired entity for its own use in conjunction with Assets A and B (related assets). The entity measures the fair value of each of the assets individually, consistently with the specified unit of account for the assets. The entity determines that there is no alternative use for the assets (the highest and best use of the assets is their current use) and that each asset would provide maximum value to market participants principally through its use in combination with other assets as a group (ie the valuation premise is ‘in use’).
- IE3 In this instance, the reporting entity would sell the assets in the market in which it initially acquired the assets (ie the ‘entry’ and ‘exit’ markets from the perspective of the reporting entity are the same). Market participant buyers with whom the reporting entity would trade in that market have characteristics that are generally representative of both financial buyers and strategic buyers and include those buyers that initially bid for the assets.* As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:
- (a) Strategic buyer asset group. The entity determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (market participant synergies). Those assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold on its own at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are CU360,* CU260 and CU30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is CU650.
 - (b) Financial buyer asset group. The entity determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (the billing software) would be used for its full remaining economic life. The

* Although market participant buyers might be broadly classified as strategic or financial buyers, there will often be differences among the market participant buyers within each of those groups, reflecting, for example, different uses for an asset and different operating strategies.

* In these [draft] examples, monetary amounts are denominated in ‘currency units (CU)’.

indicated fair values of Assets A, B and C within the financial buyer asset group are CU300, CU200 and CU100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is CU600.

- IE4 The fair values of Assets A, B and C would be determined on the basis of the use of the assets as a group within the strategic buyer group (CU360, CU260 and CU30). Although the use of the assets within the strategic buyer group does not maximise the fair value of each of the assets individually, it maximises the fair value of the assets as a group (CU650).

Example 2—Land

- IE5 An entity acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. As an industrial property (the current use), the indicated value of the land and factory is CU100,000 and CU60,000, respectively. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, the entity determines that the land currently used as a site for a factory could be developed as a site for residential use (for high-rise apartment buildings).
- IE6 The highest and best use of the land would be determined by comparing (a) the value of the land as currently developed for industrial use ('in use') and (b) the value of the land as a vacant site for residential use, considering the costs of demolishing the factory and other costs necessary to convert the land to a vacant site ('in exchange'). In this situation, the highest and best use of the land would be to develop high-rise apartment buildings ('in exchange'). As a residential property, the indicated fair value of the vacant site is CU300,000 after considering the costs to demolish the factory and other costs of conversion to a vacant site.
- IE7 Because the current use of the land differs from its highest and best use, the fair value of the asset group (land and factory) has two components: (a) the value of the assets assuming their current use as industrial property and (b) the amount by which the fair value of the assets differs from their value in their current use. The amount in (b) is determined by subtracting the current-use value of the land and factory (CU160,000) from the fair value of the vacant site (CU300,000).
- IE8 The entity measures the land at CU240,000. This is the current-use value of the land (CU100,000) plus the incremental value of the land (CU140,000) that relates to the ability to convert the land from its current use to its highest and best use. The entity measures the factory at CU60,000. The entity accounts for the assets in accordance with the FRSS applicable to those assets.

Example 3—Research and development project

- IE9 An entity 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 R&D projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (lock up) the R&D project to prevent its competitors from obtaining access to the technology. The project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology. To measure the fair value of the R&D project at initial recognition, the highest and best use of the project would be determined on the basis of its use by market participants. For example:
- (a) the highest and best use of the R&D project would be to continue development (thus the in-use valuation premise would be appropriate) if market participants would continue to develop it and that use would maximise the value of the group of assets in which the project would be used. That might be the case if market participants do not have similar technology (in development or commercialised). The fair value of the R&D project, measured using an in-use valuation premise, would be determined on the basis of 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 as a group and that those assets would be available to market participants.

- (b) the highest and best use of the R&D project would be to cease development (thus the in-use valuation premise would be appropriate) if, for competitive reasons, market participants would lock up the project and that use would maximise the value of the group of assets in which the project would be used (as a locked-up project). That might be the case if market participants have technology in a more advanced stage of development that would compete with the R&D project (if completed) and the project would be expected to provide defensive value (if locked up). The fair value of the R&D project, measured using an in-use valuation premise, would be determined on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used (locked up) with its complementary assets as a group and that those assets would be available to market participants.
- (c) the highest and best use of the R&D project would be to cease development (thus the in-exchange valuation premise would be appropriate) if market participants would discontinue its development. That might be the case 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 R&D project, measured using an in-exchange valuation premise, would be determined on the basis of the price that would be received to sell the R&D project by itself (which might be nil).

Valuation techniques

IE10 The [draft] FRS notes that a single valuation technique will be appropriate in some cases. In other cases, multiple valuation techniques will be appropriate. Examples 4 and 5 illustrate the use of multiple valuation techniques.

Example 4—Machine held and used

IE11 An entity acquired a machine in a business combination that is held and used in its operations. The machine, initially purchased from an outside vendor, was subsequently customised by the entity for use in its operations. However, the customisation of the machine was not extensive. The entity determines that the asset would provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use). Therefore, the highest and best use of the machine is its current use and the valuation premise is 'in use'.

IE12 The entity determines that sufficient data are available to apply the cost approach and, because the customisation of the machine was not extensive, the market approach. The income approach is not used because the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows. Furthermore, information about short-term and intermediate-term lease rates for similar used machinery that otherwise could be used to project an income stream (lease payments over remaining service lives) is not available. The market and cost approaches are applied as follows:

- (a) The market approach is applied using quoted prices for similar machines adjusted for differences between the machine (as customised) and the similar machines. The measurement reflects the price that would be received for the machine in its current condition (used) and location (installed and configured for use). The fair value indicated by that approach ranges from CU40,000 to CU48,000.
- (b) The cost approach is applied by estimating the amount that would currently be required to construct a substitute (customised) machine of comparable utility. The estimate considers the condition of the machine and the environment in which it operates, including physical wear and tear (physical deterioration), improvements in technology (functional obsolescence), conditions external to the condition of the machine such as a decline in the market demand for similar machines (economic

obsolescence) and installation costs. The fair value indicated by that approach ranges from CU40,000 to CU52,000.

- IE13 The entity determines that the fair value indicated by the market approach is more representative of fair value than the fair value indicated by the cost approach and, therefore, ascribes more weight to the results of the market approach. That determination is made on the basis of the relative subjectivity of the inputs, considering the degree of comparability between the machine and the similar machines. In particular:
- (a) the inputs used in the market approach (quoted prices for similar machines) require fewer and less subjective adjustments than the inputs used in the cost approach.
 - (b) the range indicated by the market approach overlaps with, but is narrower than, the range indicated by the cost approach.
 - (c) there are no known unexplained differences (between the machine and the similar machines) within that range.

The entity further determines that the higher end of the range indicated by the market approach is most representative of fair value, largely because the majority of relevant data points in the market approach lie at or near the higher end of the range. Accordingly, the entity determines that the fair value of the machine is CU48,000.

- IE14 If customisation of the machine was extensive or if there were not sufficient data available to apply the market approach (eg because market data reflect an in-exchange valuation premise [scrap value for specialised assets] rather than an in-use valuation premise), the entity would apply the cost approach. When using an in-use valuation premise, the cost approach assumes the sale of the machine to a market participant buyer with complementary assets. The price received for the sale of the machine (exit price) would not be more than the cost that a market participant buyer would incur to acquire or construct a substitute machine of comparable utility. Nor would that price be more than the economic benefit that a market participant buyer would derive from the use of the machine.

Example 5—Software asset

- IE15 An entity acquires a group of assets. The asset group includes an income-producing software asset internally developed for licence to customers and its complementary assets (including a related database with which the software asset is used). To allocate the cost of the group to the individual assets acquired, the entity measures the fair value of the software asset. The entity determines that the software asset would provide maximum value to market participants through its use in combination with other assets (its complementary assets) as a group. Therefore, the highest and best use of the software asset is its current use and the valuation premise is 'in use'. (In this case, the licensing of the software asset, in and of itself, does not make the valuation premise of the software asset 'in exchange'.)
- IE16 The entity determines that, in addition to the income approach, sufficient data might be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available. The income and cost approaches are applied as follows:
- (a) The income approach is applied using a present value technique. The cash flows used in that technique reflect the income stream expected to result from the software asset (licence fees from customers) over its economic life. The fair value indicated by that approach is CU15 million.
 - (b) The cost approach is applied by estimating the amount that would be required currently to construct a substitute software asset of comparable utility (considering functional and economic obsolescence). The fair value indicated by that approach is CU10 million.

- IE17 Through its application of the cost approach, the entity determines that market participants would not be able to construct a substitute software asset of comparable utility. Some characteristics of the software asset are unique, having been developed using proprietary information, and cannot be readily replicated. The entity determines that the fair value of the software asset is CU15 million, as indicated by the income approach.

Fair value hierarchy

- IE18 Example 6 illustrates the use of Level 1 inputs to measure the fair value of an asset that trades in different active markets with different prices.

Example 6—Level 1 most advantageous market

- IE19 An asset is sold in two different active markets with different prices. An entity enters into transactions in both markets. In Market A, the price that would be received is CU27, transaction costs in that market are CU2 and the costs to transport the asset to that market are CU3 (the net amount that would be received is CU22). In Market B, the price that would be received is CU26, transaction costs in that market are CU2 and the costs to transport the asset to that market are CU1 (the net amount that would be received in Market B is CU23).
- IE20 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 considering transaction costs and transport costs.
- IE21 Because the entity would maximise the net amount that would be received for the asset in Market B (CU23), the fair value of the asset would be measured using the price in that market (CU26), less transport costs (CU1), resulting in a measurement of CU25. Although transaction costs are considered 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).

Transaction prices and fair value at initial recognition

- IE22 Example 7 illustrates when the price in a transaction involving a derivative instrument might (and might not) equal the fair value of the instrument at initial recognition.

Example 7—Interest rate swap at initial recognition

- IE23 Entity A (a retail counterparty) enters into an interest rate swap in a retail market with Entity B (a securities dealer) for no initial consideration (transaction price is zero). Entity A can access only the retail market. Entity B can access both the retail market (with retail counterparties) and the inter-dealer market (with securities dealer counterparties).
- (a) From the perspective of Entity A, the retail market in which it initially entered into the swap is the most advantageous market for the swap; if Entity A were to transfer its rights and obligations under the swap, it would do so with a securities dealer counterparty in that market. In that case, the transaction price (zero) would represent the fair value of the swap to Entity A at initial recognition, ie the price that Entity A would receive (or pay) to sell (or transfer) the swap in a transaction with a securities dealer counterparty in the retail market (an exit price). That price would not be adjusted for any incremental (transaction) costs that would be charged by that securities dealer counterparty.
- (b) From the perspective of Entity B, the inter-dealer market (not the retail market) is the most advantageous market for the swap; if Entity B were to transfer its rights and obligations under the swap, it would do so with a securities dealer in that market. Because the market in which Entity B initially entered into the swap is different from the most advantageous market for the swap, the transaction price (zero) would not

necessarily represent the fair value of the swap to Entity B at initial recognition. If the fair value differs from the transaction price (zero), Entity B applies FRS 39 *Financial Instruments: Recognition and Measurement* to determine whether it recognises that difference as a gain or loss.

Restricted assets

- IE24 Examples 8 and 9 illustrate the effect of restrictions when measuring the fair value of an asset.

Example 8—Restriction on the sale of an equity instrument

- IE25 An entity holds an equity instrument (a financial asset) for which sale is legally restricted for a specified period. (For example, such a restriction could limit sale to qualifying investors.) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants. In that case, the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment will vary depending on the nature and duration of the restriction, the extent to which buyers are limited by the restriction (eg there might be a large number of qualifying investors) and factors specific to both the instrument and the issuer (qualitative and quantitative).

Example 9—Restrictions on the use of an asset

- IE26 A donor contributes land in an otherwise developed residential area to a not-for-profit neighbourhood association. The land is currently used as a playground. The donor specifies that the land must continue to be used by the association as a playground in perpetuity. Upon review of relevant documentation (legal and other), the association determines that the fiduciary responsibility to meet the donor's restriction would not be transferred to market participants if the association sold the asset, ie the donor restriction on the use of the land is specific to the association. Furthermore, the association is not restricted from selling the land.

Without the restriction on the use of the land by the association, the land could be used as a site for residential development. In addition, the land is subject to an easement (a legal right that enables a utility to run power lines across the land).

- (a) *Donor restriction on use of land.* Because in this instance the donor restriction on the use of the land is specific to the association, the restriction would not be transferred to market participants. Therefore, the fair value of the land would be based on the higher of its fair value 'in use' as a playground or fair value 'in exchange' as a site for residential development, regardless of the restriction on the use of the land by the association.
- (b) *Easement for utility lines.* Because the easement for utility lines is specific to (a characteristic of) the land, it would be transferred to market participants with the land. Therefore, the fair value measurement of the land would consider the effect of the easement, regardless of whether the valuation premise is 'in use' as a playground or 'in exchange' as a site for residential development.

Liabilities and credit risk

- IE27 Non-performance risk relating to a liability includes an entity's credit risk. An entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value because those who hold the entity's obligations as assets would consider the effect of the entity's credit standing in determining the prices they would be willing to pay. For example, assume that Entity X and Entity Y each

enter into a contractual obligation to pay cash (CU500) to Entity Z in five years. Entity X has an AA credit rating and can borrow at 6 per cent, while Entity Y has a BBB credit rating and can borrow at 12 per cent. Entity X will receive about CU374 in exchange for its promise (the present value of CU500 in five years at 6 per cent). Entity Y will receive about CU284 in exchange for its promise (the present value of CU500 in five years at 12 per cent). At initial recognition, the fair value of the liability to each entity (the proceeds) incorporates that entity's credit standing. Example 10 illustrates the effect of credit standing on the fair value of a financial liability at initial recognition and in subsequent periods.

Example 10—Structured note

IE28 On 1 January 20X7 Entity A, an investment bank with an AA credit rating, issues a five-year fixed rate note to Entity B. No credit enhancements are issued in conjunction with or otherwise related to the contract (ie no collateral is posted and there is no third-party guarantee). Entity A elects to account for the entire note at fair value in accordance with FRS 39. The fair value of the note (the obligation of Entity A) during 20X7 is measured using an expected present value technique. Changes in fair value are discussed below.

- (a) *Fair value at 1 January 20X7.* The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the government bond curve at 1 January 20X7), plus the current market observable AA corporate bond spread to government bonds adjusted (up or down) for Entity A's specific credit risk (credit-adjusted risk-free rate). Therefore, the fair value of Entity A's obligation at initial recognition considers non-performance risk, including that entity's credit risk (presumably, reflected in the proceeds).
- (b) *Fair value at 31 March 20X7* During March 20X7, the credit spread for AA corporate bonds widens, with no changes to the specific credit risk of Entity A. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the government bond curve at 31 March 20X7), plus the current market observable AA corporate bond spread to government bonds, adjusted for Entity A's specific credit risk (credit-adjusted risk-free rate). Entity A's specific credit risk is unchanged from initial recognition. Therefore, the fair value of Entity A's obligation changes as a result of changes in credit spreads generally. Changes in credit spreads reflect current market participant assumptions about changes in non-performance risk generally.
- (c) *Fair value at 30 June 20X7.* As of 30 June 20X7, there have been no changes to the AA corporate bond spreads. However, on the basis of structured note issues corroborated with other qualitative information, Entity A determines that its own specific creditworthiness has strengthened within the AA credit spread. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the government bond yield curve at 30 June 20X7), plus the current market observable AA corporate bond spread to government bonds (unchanged from 31 March 20X7), adjusted for Entity A's specific credit risk (credit-adjusted risk-free rate). Therefore, the fair value of the obligation of Entity A changes as a result of the change in its own specific credit risk within the AA corporate bond spread.

Fair value measurements in markets that are not active

IE29 Example 11 illustrates the use of judgement when measuring the fair value of a financial asset when the market for that financial asset is not active.

Example 11—Inactive market

IE30 Entity A invested in a junior AAA-rated tranche of a residential mortgage-backed security (RMBS) on 1 January 20X8 (the issue date of the security). The junior tranche is the third most senior of a total of seven tranches. The underlying collateral for the RMBS is unguaranteed residential mortgage loans that were issued in the second half of 20X6.

- IE31 At 31 March 20X9 (the measurement date), the junior tranche is now A-rated. This tranche of the RMBS was previously traded through a brokered market. However, trading volume in that market was infrequent, with only a few transactions taking place per month from 1 January 20X8 to 30 June 20X8 and little, if any, trading activity during the nine months before 31 March 20X9.
- IE32 Entity A considers the factors in paragraph B5 of the [draft] FRS to determine whether the market for the junior tranche of the RMBS is not active. After evaluating the significance and relevance of the factors, Entity A concludes that the market is not active. Entity A supported its judgement primarily on the basis that there was little, if any, trading activity for an extended period of time before the measurement date.
- IE33 Because there is little, if any, trading activity to support a valuation technique using a market approach, Entity A decides to use an income approach to estimate the fair value of its security at the measurement date. Entity A estimates a discount rate (ie market rate of return) to discount the contractual cash flows from the RMBS. The market rate of return is estimated using the risk-free rate of interest and a margin that reflects the risks (eg default risk, collateral value risk and liquidity risk) that market participants would consider when pricing the asset in an orderly transaction at the measurement date.
- IE34 Entity A considered the following information when estimating the margin:
- (a) the credit spread for the junior tranche of the RMBS at the issue date as implied by the original transaction price
 - (b) the change in the credit spread implied by any observed transactions from the issue date to the measurement date for comparable RMBSs or on the basis of relevant indices
 - (c) the characteristics of the junior tranche of the RMBS compared with comparable RMBSs or indices, including the quality of the underlying assets (ie information about the performance of the underlying mortgage loans such as delinquency and foreclosure rates, loss experience and prepayment rates), seniority or subordination of the RMBS tranche held and other relevant factors
 - (d) relevant reports issued by analysts and rating agencies
 - (e) quoted prices from third parties such as brokers or pricing services.
- IE35 Entity A estimates that one indication of the market rate of return that market participants would use when pricing the junior tranche is 12 per cent (1,200 basis points). This market rate of return was estimated as follows:
- (a) 300 basis points for the relevant risk-free rate of interest at 31 March 20X9.
 - (b) Add: 250 basis points for the credit spread over the risk-free rate when the junior tranche was issued in January 20X8.
 - (c) Add: 700 basis points for the estimated change in the credit spread over the risk-free rate of the junior tranche between 1 January 20X8 and 31 March 20X9. This estimate was based on the change in the most comparable index available for that time period.
 - (d) Subtract: 50 basis points (net) to adjust for differences between the index used to estimate the change in credit spreads and the junior tranche. The reference index consists of subprime mortgage loans, while Entity A's RMBS consists of mortgage loans with a more favourable credit profile (making it more attractive to market participants). However, the index does not reflect an appropriate liquidity risk premium for the junior tranche under current market conditions. Thus, the 50 basis point adjustment is the net of two adjustments:

- (i) the first adjustment is a 350 basis point subtraction, which was estimated by comparing the implied yield from the most recent transactions for the RMBS in June 20X8 with the implied yield in the index price on those same dates. There was no information available that indicated that the relationship between Entity A's security and the index has changed.
- (ii) the second adjustment is a 300 basis point addition, which is Entity A's best estimate of the additional liquidity risk inherent in its security (a cash position) when compared with the index (a synthetic position). This estimate was derived after considering liquidity risk premiums implied in recent cash transactions for a range of similar securities.

IE36 As an additional indication of the market rate of return, Entity A considers two recent indicative quotes (ie non-binding quotes) provided by reputable brokers for the junior tranche that imply yields of 15–17 per cent. Entity A is unable to evaluate the valuation techniques or inputs used to develop the quotes. However, Entity A is able to confirm that the quotes are not based on transactions.

IE37 Because Entity A has multiple indications of the market rate of return that market participants would consider when measuring fair value, it evaluates and weights the respective indications of the rate of return, considering the reasonableness of the range indicated by the results.

IE38 Entity A concludes that 13 per cent is the point within the range of indications that is most representative of fair value under current market conditions. Entity A placed more weight on the 12 per cent indication (ie its own estimate of the market rate of return) for the following reasons:

- (a) Entity A concluded that its own estimate appropriately incorporated the risks (eg default risk, collateral value risk and liquidity risk) that market participants would use when pricing the asset in an orderly transaction under current market conditions
- (b) the broker quotes were non-binding and were not based on transactions and Entity A was unable to evaluate the valuation techniques or inputs used to develop the quotes.

Fair value disclosure

IE39 The disclosures required by paragraph 57(a) and (b) and paragraph 57(e) and (f) of the [draft] FRS are illustrated below.

Example 12—Assets measured at fair value

IE40 For assets and liabilities measured at fair value during the period, the [draft] FRS requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. An entity might disclose the following for assets to comply with paragraph 57(a) and (b) of the [draft] FRS:

Assets measured at fair value				
Description	31Dec 20X2	Fair value measurement at the end of the reporting period using:		
		Quoted prices in active markets for identical assets (Level 1) CU million	Significant other observable inputs (Level 2) CU million	Significant unobservable inputs (Level 3) CU million
Financial assets at fair value through profit or loss				
Trading securities	100	40	55	5
Trading derivatives	39	17	20	2
Available-for-sale financial assets				
Equity investments	75	30	40	5
Investment properties				
Land	40	-	25	15
Buildings	15	-	-	15
Total	269	87	140	42

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

Example 13—Fair value measurements in Level 3 of the fair value hierarchy

- IE41 For assets and liabilities measured at fair value in Level 3 of the fair value hierarchy, the [draft] FRS requires a reconciliation from the opening balances to the closing balances for each class of assets and liabilities. An entity might disclose the following for assets to comply with paragraph 57(e) and (f) of the [draft] FRS:

Assets measured at fair value in Level 3 of the fair value hierarchy						
Fair value measurement at the end of the reporting period						
	Financial assets at fair value through profit or loss		Available-for-sale Financial assets	Investment properties		Total
	Trading securities	Trading derivatives	Equity investments	Land	Buildings	
	CU million	CU million	CU million	CU million	CU million	CU million
Opening balance	6	5	4	10	12	37
Total gains or losses						
in profit or loss	(2)	(2) ^(a)	-	5	3	4
in other comprehensive income	-	-	(1)	-	-	(1)
Purchases	1	2	2	-	-	5
Issues	-	-	-	-	-	-
Settlements	-	(1)	-	-	-	(1)
Transfers into or out of Level 3	-	(2)	-	-	-	(2)
Closing balance	<u>5</u>	<u>2</u>	<u>5</u>	<u>15</u>	<u>15</u>	<u>42</u>
Gains or losses in profit or loss for assets held at the end of the reporting period	<u>(1)</u>	<u>(1)</u>	<u>-</u>	<u>5</u>	<u>3</u>	<u>6</u>

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

- (a) Losses of CU0.05 that have been reported in Level 3 are offset by gains or losses on instruments categorised within Level 1 or Level 2 of the fair value hierarchy.

Gains and losses in profit or loss for the period (above) are reported in trading income and in other income as follows:

	Trading income CU million	Other income CU million
Total gains or losses included in profit or loss for the period	<u>(4)</u>	<u>8</u>
Gains or losses in profit or loss for assets held at the end of the reporting period	<u>(2)</u>	<u>8</u>

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

Appendix

[Draft] Amendments to guidance on other FRSs

The following [draft] amendments to guidance on other FRSs are necessary in order to ensure consistency with [draft] FRS X Fair Value Measurement and the related amendments to other FRSs. Amended paragraphs are shown with new text underlined and deleted text struck through.

FRS 107 Financial Instruments: Disclosures

- IGA1 The reference to paragraph AG76A of FRS 39 in paragraph IG14 in the Guidance on Implementing FRS 107 is amended to refer to paragraph AG76(b).

FRS 39 Financial Instruments: Recognition and Measurement

- IGA2 The Guidance on Implementing FRS 39 is amended as follows:

Question and answer E.2.1 is deleted.

Question and answer E.2.2 is amended as follows:

E.2.2 Fair value measurement: large holding

Entity A holds 15 per cent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is CU100. Daily trading volume is 0.1 per cent of outstanding shares. Because Entity A believes that it could sell its share in the fair value of the Entity B shares it owns, if sold as a block, is greater for more than the quoted market price, Entity A obtains ~~several~~ independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A ~~would be able to~~ obtain a price of CU105, ie a 5 per cent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

~~Under In accordance with FRS 39.48A AG74, a published price quotation in an active market is the best estimate of fair value if there is a quoted price in an active market for a financial instrument the fair value of the holding is the product of that price and the number of units held.~~ Therefore, Entity A uses the published price quotation (CU100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

INT FRS 113 Customer Loyalty Programmes

- IGA3 In the illustrative examples accompanying INT FRS 113, paragraphs IE1–IE5 are amended as follows:

IE1 A grocery retailer operates a customer loyalty programme. It grants programme members loyalty points when they spend a specified amount on groceries. Programme members can redeem the points for further groceries. The points have no expiry date. In one period, the entity grants 100 points. Management estimates that a market participant would expect 80 of these points to be redeemed. ~~Management estimates that~~ The fair value of each loyalty point to be is one currency unit (CU1), and Accordingly, management defers revenue of CU100. Throughout the example, management determines that non-performance risk has an immaterial effect on the measurement of its obligation under the programme.

Year 1

IE2 At the end of the first year, 40 of the points have been redeemed in exchange for groceries, ie half of those expected to be redeemed. The entity recognises revenue

of $(40 \text{ points}/80^* \text{ points}) \times \text{CU}100 = \text{CU}50$.

Year 2

IE3 In the second year, management revises its estimate of market participant expectations. It now expects 90 points to be redeemed altogether.

IE4 During the second year, 41 points are redeemed, bringing the total number redeemed to $40^\dagger + 41 = 81$ points. The cumulative revenue that the entity recognises is $(81 \text{ points}/90^\S \text{ points}) \times \text{CU}100 = \text{CU}90$. The entity has recognised revenue of CU50 in the first year, so it recognises CU40 in the second year.

Year 3

IE5 In the third year, a further nine points are redeemed, taking the total number of points redeemed to $81 + 9 = 90$. Management continues to estimate that market participants expect that only 90 points will ever be redeemed, ie that no more points will be redeemed after the third year. So the cumulative revenue to date is $(90 \text{ points}/90^* \text{ points}) \times \text{CU}100 = \text{CU}100$. The entity has already recognised CU90 of revenue (CU50 in the first year and CU40 in the second year). So it recognises the remaining CU10 in the third year. All of the revenue initially deferred has now been recognised.

* total number of points expected to be redeemed

† number of points redeemed in year 1

§ revised estimate of total number of points expected to be redeemed

* total number of points still expected to be redeemed