Chapter 17
HKFRS 13 “Fair Value Measurement”

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¶17-100 Introduction
HKFRS 13 “Fair Value Measurement” establishes a single source of guidance for fair value measurement under HKFRS. HKFRS 13 defines fair value, provides guidance on its determination and introduces consistent requirements for disclosures on fair value measurements (para 1). HKFRS 13 does not include requirements on when fair value measurement is required; it prescribes how fair value is to be measured if another HKFRS requires it.

Certain HKFRS, such as HKAS 40 “Investment Property” require items to be measured at fair value on an on-going basis (referred to by HKFRS 13 as “fair value on a recurring basis”). HKFRS 5 “Non-current Assets Held for Sale and Discontinued Operations”, requires fair value only in certain circumstances (referred to by HKFRS 13 as “fair value on a non-recurring basis”) while HKFRS 3 “Business Combinations” requires fair value only on initial recognition of an item.

HKFRS 13 includes a fair value hierarchy concept that prioritises 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).

¶17-200 Objective and scope
Fair value is a market-based measurement, not an entity-specific measurement (para 2). For some assets and liabilities, observable market
transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same — to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (para B2 of Application Guidance). That is an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability (para 2).

When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that maximises the use of relevant observable inputs and minimises the use of unobservable inputs (para 3). Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, whatever an entity’s intentions may be with regard to holding assets or to settling or otherwise fulfilling liabilities, these are not relevant when measuring fair value (para 3).

The definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. In addition, HKFRS 13 shall be applied to an entity’s own equity instruments measured at fair value (para 4).

HKFRS 13 applies to all transactions and balances (whether financial or non-financial) for which HKFRSs require or permit fair value measurements, with the exception of share-based payment transactions accounted for under HKFRS 2 “Share-based Payment” and leasing transactions accounted for in accordance with HKFRS 16 “Leases” (para 5).

HKFRS 13 makes a clear distinction for certain measurements that have similarities to fair value but are not fair value out of its scope. This would include net realisable value under HKAS 2 “Inventories” and valuations used under HKAS 36 “Impairment of Assets” (para 6).

The disclosure requirements of HKFRS 13 also do not apply to the following items (para 7):

(a) plan assets measured at fair value in accordance with HKAS 19 (2011) “Employee Benefits”;

(b) retirement benefit plan investments measured at fair value in accordance with HKAS 26 “Accounting and Reporting by Retirement Benefit Plans”; and

(c) assets for which the recoverable amount is fair value less costs of disposal in accordance with HKAS 36.
¶17-300 Measurement

Fair value is defined in HKFRS 13 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, i.e. an exit price (para 9 and Appendix A).

The asset or liability

A fair value measurement should consider the characteristics of the asset or liability. This would include the condition and location of the asset as well as any restrictions on its sale or use. The objective is to include those characteristics that market participants would use when determining the price of the asset or liability at the measurement date (para 11). With certain limited exceptions, the unit of account, e.g. a single asset or liability or a group of assets or liabilities, is not generally specified. Instead, the unit of account should be determined by the particular HKFRS requiring the measurement of fair value.

Illustration 17.1 (Restrictions on the use of an asset)

Entity Y acquired a factory as part of a business combination in 20x1. As a condition of the acquisition Entity Y is not allowed to change the use of the land and buildings from operation as factory for a period of three years. The area in which the factory is located has recently been re-zoned as being eligible for development as residential properties. Entity Y has received legal advice that although it is restricted under the terms of the acquisition from changing the use of the land and buildings, it can sell the land and buildings to a third party who would not be bound by the restriction.

In this case, as the restriction is a characteristic of the current holder rather than of the asset, the fair value of the land and buildings is determined as the higher of its value as a factory and its value as a site for residential development.

The transaction

Fair value is a market-based measurement, rather than an entity-specific measurement. A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions (para 15). Therefore, the entity’s intention or ability to enter into a transaction on that date is not relevant.

An orderly transaction assumes exposure to the market for a period before the measurement date to allow for customary marketing activities for transactions involving such assets or liabilities. That is, it would include extraneous factors such as forced liquidation or distress sale (Appendix A).
The hypothetical transaction to sell the asset or transfer the liability is assumed to take place in the principal market (para 16). This is the market with the greatest volume and level of activity for the asset or liability (Appendix A). In the absence of a principal market, the transaction is assumed to take place in the most advantageous market (para 16). This 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 considering transaction costs and transport costs (Appendix A). Because different entities, and different businesses within a single entity, may have access to different markets, the principal or most advantageous market for the same asset or liability may vary from one entity to another, or between businesses within an entity.

An entity is not required to undertake an exhaustive search of all possible markets to identify the principal or most advantageous market; however, it should take account of all information that is reasonably available (para 17). For example, if reliable information for comparable transactions is available in trade magazines or websites, it may be appropriate to take this information into account to determine the principal market. The principal or most advantageous market is generally presumed to be the market in which an entity normally enters into transactions for the asset or liability.

**Market participants**

Fair value measurement uses assumptions that market participants would use in pricing the asset or liability and act in their economic best interest (para 22). Market participants are buyers and sellers in the principal (or most advantageous) market who are independent of each other, knowledgeable about the asset or liability, and willing and able to enter into a transaction for the asset or liability (Appendix A).

Market participants should be knowledgeable participants. Thus, if a market participant was willing to enter into a transaction it would generally undertake efforts, such as due diligence, to become knowledgeable about the asset or liability and would factor any uncertainty into its pricing of the asset or liability. In order to reduce the price adjustment that would normally arise from a lack of information, a seller therefore has an incentive to cooperate with the buyer and to share information and knowledge under its control.

**The price**

Fair value is the price that would apply in a transaction between market participants. This may be directly observable in an active market or estimated using a valuation technique (para 24). The price is not adjusted for transaction costs as these costs are not an inherent characteristic of the asset or liability (para 25). However, transaction costs may be considered when determining the most advantageous market. For example, if the production location is a characteristic of an asset (such as oil or wheat) the price is adjusted for costs to transport the asset to or from that market (para 26).
¶17-400 Valuation techniques

General principles

The objective of using a valuation technique is to determine the price at which an orderly transaction would take place between market participants at the measurement date (para 62). An entity uses valuation techniques that are appropriate in the circumstances and for which sufficient data are available. It should attempt to maximise the use of relevant observable inputs and minimise the use of unobservable inputs (para 61 and 67).

HKFRS 13 refers to a “valuation approach” as a broad category of techniques whereas a “valuation technique” refers to a specific technique such as the Black-Scholes option pricing model. Valuation techniques used to measure fair value fall into three main approaches (para 62):

(a) market;  
(b) income; and  
(c) cost.

An entity may use one or a combination of the three approaches to measure fair value — assuming the combination of techniques adopted are appropriate to the circumstances. When multiple valuation techniques are used an entity will need to apply significant judgment and external expertise may be required. Thus, entities need to carefully consider the reliability of the valuation techniques employed as well as the inputs used within those techniques. Generally, entities should attempt to use the highest level inputs available; for example, observable market prices would carry greater weight than, say, internally generated income projections or pricing models. Valuation techniques should be applied consistently unless a change in technique or its application results in a measurement that is equally or more representative of fair value in the circumstances (para 65). This might happen where new information becomes available or valuation techniques improve.

Market approach

A market approach will generally involve market multiples from a set of comparable assets (para B6 of Application Guidance).

A market multiple expresses the value of an asset in terms of its ratio to a financial, operating or physical metric (e.g. a price to earnings ratio). The multiple is applied to the metric of an entity with similar characteristics subject to adjustments for differences between the specific asset and the selected comparable. When multiples are derived from a number of comparable entities, there will usually be a range calculated. Selection within the range is generally based on a market participant’s assumptions and expectations. For example, in estimating the fair value of an operating division, an entity may consider differences between the division and
comparable divisions in terms of size, growth, workforce, profitability, risk, capital requirements, etc.

Matrix pricing is included in HKFRS 13 as an example of a valuation technique falling under the market approach. Matrix pricing is a mathematical technique used mainly to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities (para B7 of Application Guidance). Therefore, matrix prices are based on quoted prices for securities with similar coupons, ratings and maturities, rather than on actual prices for the asset being measured. The term “matrix price” refers to the practice of interpolating among values for similar instruments arranged in a matrix format. These model prices must be used with care and with understanding that a specific position may be highly illiquid.

**Income approach**

The income approach converts future amounts, such as cash flows and outflows, to a single current (i.e. discounted) amount (para B10 of Application Guidance).

The income approach will reflect market expectations about the likelihood of these future amounts, for example, growth rates, customer churn rates, inflation, etc.

Some of the more established valuation techniques include the following (para B11 of Application Guidance):

- (a) net present value;
- (b) option pricing models, such as the Black-Scholes-Merton formula or a binomial model, often used to price options; and
- (c) multi-period excess earnings method, often used to measure the fair value of intangible assets.

**Present value techniques**

The application guidance in HKFRS 13 includes two approaches to applying a present value technique:

- (a) discount rate adjustment; and
- (b) expected present value.

HKFRS 13 does not prescribe a specific method. Present value technique used to measure fair value will depend on the pertinent facts and circumstances (para B12 of Application Guidance). An entity needs to consider the dynamics of the specific asset or liability being measured along with the availability of relevant data. This may include cash flow estimates, risk premiums, discount rates and other factors that would be necessary to complete the fair value measurement.
Present value techniques may differ in certain approaches, but entities should consider the importance and relevance of the following (para B14 of Application Guidance):

(a) cash flows and discount rates should be specific to a market participant’s situation;

(b) assumptions which are extraneous to the asset or liability should be excluded;

(c) discount rates should reflect the assumptions and risks inherent to the cash flows; and

(d) assumptions about the cash flows should be consistent. For example, inflation, interest or foreign exchange rates should be used consistently within the calculations.

**Risk and uncertainty**

Assumptions around cash flows will almost always contain some level of uncertainty. For example, even the repayment of a line of credit is subject to the risk of default. Thus, it may be necessary to employ risk premiums in order to adjust the fair value measurement to reflect the estimated cash flows an entity would ordinarily expect to receive.

HKFRS 13 includes two methods to adjust for risk in cash flows models (para B17 of Application Guidance):

(a) method 1 adjusts for risk within the expected cash flows, which are subsequently discounted at the risk-free rate;

(b) method 2 uses a risk-adjusted discount rate with unadjusted expected cash flows.

No single method is preferred for making these adjustments. An entity must decide, based upon the relevant facts and circumstances, which method is more applicable to the asset or liability being measured. Risk adjustments may appear in both cash flows and the discount rate; thus, entities should ensure such risk adjustments are not being counted twice within the calculations.

**Cost approach**

The cost approach principally adopts a depreciated replacement cost method to calculate fair value (para B8 of Application Guidance).

The cost approach considers the cost to reproduce an asset of equivalent function taking into account physical, utility and economic obsolescence. It focuses on the replacement cost of the capacity of the asset rather than the actual asset — as a buyer would not pay more than the amount to replace the service capacity of that asset. In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets.

The cost approach is not relevant for financial assets.
Inputs to valuation techniques

Inputs to valuation techniques represent the assumptions used to price an asset or a liability. Such assumptions may include the inherent risks of using a particular valuation technique or the inherent risks of certain specific input values. Entities are required to select the valuation techniques and inputs that are appropriate for the fact and circumstances. In addition, they need to consider the types of data generally available and seek to maximise the use of Level 1 inputs and minimise the use of Level 3 inputs (see below).

Premiums, discounts and blockage factors

In certain instances, an entity may need to consider inputs that require the application of an adjustment — for example, a control premium or a non-controlling interest discount. The decision to include a premium or discount in a fair value measurement is a complex matter and may require professional judgment.

Factors to consider include:

1. the unit of account;
2. availability of Level 1 inputs; and
3. the likelihood market participants would include a premium or discount in a transaction.

Fair value measurements do not include characteristics of how an entity holds an asset. For example, where an entity has a large holding of a certain quoted security, selling the holding in a single transaction may affect the quoted price. HKFRS 13 confirms that such a blockage factor is not a characteristic of the asset but of the size of the holding. Accordingly, where a blockage factor is specific to the entity it should not be included in the fair value measurement.

Illustration 17.2

Company Q executes a contract to buy 55% of the equity in Company Z, a listed company. A Level 1 price is available for the share price but not for the specific contract price to buy 55%. The fair value of the contract would therefore take into account any necessary adjustments to the share price to reflect the value (controlling interest) of the contract.

Some assets or liabilities measured at fair value have a bid and ask price. In such cases, an entity uses the price within the bid-ask spread that is the most representative of fair value in the circumstances (para 70).
¶17-500  Fair value hierarchy

To increase consistency and comparability in fair value measurements (and the related disclosures), HKFRS 13 includes a fair value hierarchy. This uses three levels of categories for the inputs to the valuation techniques. The hierarchy gives the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs (para 72).

Level 1 inputs are quoted prices, unadjusted, in active markets for identical assets or liabilities at the measurement date (para 76). Level 2 are inputs other than quoted prices included within Level 1 that that are observable for the asset or liability, either directly or indirectly (para 81). Level 3 inputs are inputs that are not based on observable market data — referred to as unobservable inputs within HKFRS 13 (para 86).

A fair value measurement is categorised in its entirety at the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

Level 1 inputs

Level 1 inputs will be available for many financial assets and financial liabilities. Various prices may exist where such assets and liabilities are quoted on multiple exchanges around the world. The emphasis for Level 1 inputs is on determining both of the following (para 78):

(a) the principal market for the asset or liability (or in the absence of a principal market the most advantageous market); and

(b) whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date.

Level 1 prices should generally not be adjusted. However, HKFRS 13 provides limited circumstances in which an adjustment may be appropriate (para 79):

(a) Where an entity uses an alternative method that does not rely exclusively on quoted prices such as matrix pricing. This exception is only appropriate when the following criteria are met:
– the entity holds a large number of similar assets or liabilities measured at fair value; and
– a quoted price in an active market is available but these data are not readily accessible for each of these assets or liabilities individually (this could occur, for example, if an entity holds thousands of securities within a portfolio).

(b) If a quoted price in an active market does not represent fair value at the measurement date, an entity should establish a policy to identify such circumstances and disclose these facts accordingly. This could occur, for example, where a merger is announced after the close of a market but before the measurement date.

Any other adjustments to quoted (Level 1) prices will result in the fair value measurement being classified into a lower level of the fair value hierarchy.

**Level 2 and Level 3 inputs**

The determination of whether inputs should be classified as Level 2 or Level 3 depends on if the inputs are observable or unobservable and their relative significance to the overall fair value measurement.

Level 2 inputs are inputs that are either directly or indirectly observable for the asset or liability (para 81). Inputs are observable if they are developed on the basis of publicly available information about actual events or transactions and reflect the assumptions that market participants would use when pricing the asset or liability. If the asset has a specified term, such as a 12-month futures contract, the input needs to be observable for substantially the full term of the asset or the liability to be classified as Level 2 (para 82).

Level 2 inputs include the following (para 82):

(a) quoted prices for similar assets or liabilities in active markets;
(b) quoted prices for identical or similar assets or liabilities in markets that are not active;
(c) inputs other than quoted prices that could be observed for the asset or liability, for example:
   (i) interest rates and yield curves at commonly quoted intervals;
   (ii) implied volatility; or
   (iii) credit spreads;
(d) market-corroborated inputs.

Examples of Level 2 inputs include items held in retail inventory, land and buildings currently being used or an operating division of a company with observable, comparable transactions. In respect of property, Level 2 inputs for the property valuation would be the price per square feet derived from recent market transactions for comparable or similar properties in a similar location.
Adjustments to Level 2 inputs may be necessary depending on the characteristics of the asset or liability being measured. If Level 2 inputs are adjusted, an entity should determine if the adjustment is significant to the entire measurement that uses significant unobservable inputs. If so, the fair value measurement may be classified as Level 3. For example, certain specialised properties may rarely be sold except as part of a continuing business. In this case, without any observable market transactions for those properties, the valuation is classified as Level 3.

Level 3 inputs are unobservable inputs (para 86). Entities should attempt to minimise the use of such unobservable inputs; however, circumstances may dictate that these are only inputs available. In such situations the unobservable inputs should be based on the best information available to market participants engaged in pricing assets or liabilities. Examples of Level 3 inputs include an interest rate swap (where comparable data is not available) and an operating division of a company without observable, comparable transactions.

¶17-600 Measurement — specific application issues

HKFRS 13 contains three specific application of fair value measurement to:
(a) non-financial assets;
(b) liabilities and an entity’s own equity instruments; and
(c) financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk.

¶17-610 Application to non-financial assets

Fair value measurements need to consider a market participant’s ability to generate economic benefits by either using the asset internally or by selling it to another market participant (para 27). This is referred to as its highest and best use, that is, the use of an asset that maximises the value of the asset or the group of assets or liabilities, for example a business within which the asset would be used (para 27 and Appendix A). Considerations within a fair value assessment would, of course, consider uses of the asset that are physically possible, legally permissible and financially feasible (para 28).

Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use, e.g. an entity may intend to use assets acquired in a business combination differently from other market participants (para 29). However, it is not necessary to perform an exhaustive search for other potential uses if there is no evidence to suggest that the current use of an asset is not its highest and best use.

The highest and best use of an asset establishes the following valuation premises for the fair value of that asset (para 31(a)(i) and (b)): 
(a) **In combination.** If an asset would provide maximum value to market participants principally through its use in combination with other assets as a group or in combination with other assets or liabilities, the fair value is measured on the basis of price that would be received in a current transaction to sell the asset assuming that:

– the asset would be used with other assets or with other assets and liabilities; and

– the complementary assets and associated liabilities would be available to market participants.

(b) **Stand-alone.** If an asset would provide maximum value to market participants principally on a stand-alone basis, the fair value is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a stand-alone basis.

Both the in-combination and the stand-alone valuation premises assume that the asset is sold individually and not as part of a group of assets or a business.

The highest and best use concept is not relevant for financial assets and liabilities.

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**Illustration 17.3 (Acquisition of a private label brand)**

Entity Q acquired a brand name in a business combination but decided not to continue using the brand as it believes it will generate additional revenue from its existing brands if the acquired brand is “retired”. However, from a valuation perspective, a market participant would generally choose to continue using the brand especially if did not have access to the same brands as Q. Thus, a market participant would base the fair value of the brand on the highest and best use to that market participant. This would be the case even if Q’s approach to determining fair value resulted in a higher valuation.

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**Illustration 17.4 (In combination fair values)**

Entity R acquired the assets of contractual customer relationships and in-process R&D technology within a business combination. The highest and best use of the customer relationships would either be: (1) on a stand-alone basis, or; (2) in combination with complementary assets. R understands that the relationships with customers are highly correlated to the sale of products incorporating the acquired R&D technology. A market participant without access to the technology would generally
realise a lower valuation from the customer relationships based on the expectation of lower revenue. That is, it would value the customer relationships on a stand-alone basis. However, when a market participant has access to comparable technology they would more likely realise higher revenue as they would consider the customer relationships in combination with the technology. Put another way, the technology is more valuable as a result of its use with the customer relationships. Thus, in such a scenario the fair value measurement would incorporate an in-combination approach.

\[17-620\] Application to liabilities and an entity’s own equity instruments

A fair value measurement of a financial or non-financial liability or an entity’s own equity instrument (e.g. equity interests issued as consideration in a business combination) assumes it is transferred to a market participant at the measurement date (para 34). Accordingly, there is an assumption that the transferee will be required to fulfil the liability. This concept is consistent with the exit price approach for assets. However, in many cases there is no observable market price for the transfer of a liability. Thus, the highest and best use concept does not apply to liabilities and an entity’s own equity instruments as it is unlikely these items would have an alternative use.

When quoted prices are available for similar or identical items, the fair value of a liability or an entity’s own equity instruments is measured accordingly. When such prices are not available, an entity measures the fair value from the perspective of a market participant holding the identical item as an asset (para 37). If quoted prices in an active market for a similar asset are also not available, other observable inputs are used. This may include prices in an inactive market for the asset — such as over-the-counter securities. Otherwise, an entity will be required to use a valuation technique such as present value measurement or the pricing of a similar liability or instrument.

The fair value of a liability reflects the effect of non-performance risk (para 42); this would include factors relating to the entity’s own credit risk (as defined in HKFRS 7 “Financial Instruments: Disclosures”). An entity takes into account the effect of its credit risk on the fair value of the liability in all periods in which the liability is measured at fair value because those that hold the entity’s obligations as assets would take into account the effect of the entity’s credit standing when estimating the prices they would be willing to pay.

For example, assume two entities (X and Y) enter into a contractual obligation to pay $50 million to entity Z in 10 years. If X has a AA credit rating and can borrow at 3%, and Y has a BB credit rating and can borrow at 6%, X will receive a sum equal to the present value $50 million in 10 years priced at 3%
and Y will receive a sum equal to the present value of $50 million in 10 years priced at 6%. Accordingly, the fair value of the liability to each entity, that is the proceeds each will receive, appropriately reflects that entity’s credit standing.

HKFRS 13 also provides that the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the present value of the amount payable on demand (para 47).

**Restriction preventing the transfer of a liability or an entity’s own equity instrument**

When measuring the fair value of a liability or an entity’s own equity instrument, it is not appropriate to include an adjustment relating to the existence of a restriction that prevents the transfer of the item (para 45). This is because such a restriction should be either implicitly or explicitly included in the inputs used to measure fair value.

For example, if both the creditor and debtor accepted the transaction price for the liability knowing that it included a restriction preventing its transfer, a separate input factor (or an adjustment) is not necessary to reflect the economic impact of the restriction on transfer (para 46). This would be applicable for all measurement dates during which the restriction was operable.

¶17-630 Application to financial assets and financial liabilities (with offsetting positions in market risks or counterparty credit risk)

If an entity manages a group of financial assets and liabilities that are measured at fair value on the basis of its net exposure to market or credit risks (as defined in HKFRS 7), it is permitted to value that group based on its net exposures to particular risks — assuming this is in accordance with its documented investment strategy and such information is regularly reported on this basis to its key management personnel (para 48).

The use of this exception should be documented as an accounting policy and fair value would be determined consistently with how market participants price the net risk exposure. Net credit risk exposures would reflect any mitigating arrangements in the event of default, assuming market participants would ordinarily take these arrangements into account. This exception is permitted because the measurement of financial instruments in a group by market participants is considered to be a market-based measurement.

Measuring on a net exposure basis is permitted, if the entity meets the following conditions:
**Exposure to market risks**

Within a portfolio of financial instruments, an entity may be exposed to market risks which may be offset in determining its net exposure. Such risks should be substantially the same in terms of both their nature and duration (para 54). For example, an entity could not offset the credit risk associated with a financial asset against the interest rate risk associated with a financial liability. These risks would not qualify as being substantially the same and, thus, would not qualify for the exception.

The duration of the entity’s exposure to market risk should be substantially the same. For example, if an entity has a 24-month interest rate swap contract it wishes to net against a ten-year debt instrument, it may net the exposure for 24 months. The remaining interest rate risk exposure (years 3-10) would need to be measured on a gross basis.

**Exposure to the credit risk of a particular counterparty**

When using the exception to measure the fair value of a group of financial assets and financial liabilities entered into with a particular counterparty, an entity shall include the effect of its net exposure to the credit risk of that counterparty or the counterparty’s net exposure to the credit risk of the entity in the fair value measurement (para 56). Thus, the entity would take into account any arrangements that mitigate credit risk exposure in the event of default. This ordinarily involves the use of a master netting agreement with the counterparty or an agreement that requires the exchange of collateral on the basis of each party’s net exposure to the credit risk of the other party. The fair value measurement would reflect the market participants’ expectations regarding the likelihood that such an arrangement would be legally enforceable in the event of default. That is, an entity would only take into consideration a master netting agreement if market participants would generally do so. Thus, the net credit risk exposure identified would refer to
either the entity’s net exposure to the credit risk of the counterparty or the counterparty’s net exposure to the entity’s own credit risk.

§17-700 Fair value at initial recognition

The transaction price to acquire an asset or assume a liability (entry price) is unlikely to equal the fair value of that asset or liability based on an exit price. If an entity is required or permitted to measure an asset or liability initially at fair value under a HKFRS and the transaction price differs from fair value, the entity would recognise the resulting gain or loss in profit or loss at the transaction date unless otherwise required by the specific HKFRS (para 60). Accordingly, the recognition of such “day one” gains or losses is determined by the particular Standard that prescribes the accounting for the asset or liability.

HKFRS 13 has not introduced a substantive change in the existing guidance regarding the recognition of a day one gain or loss on a financial instrument. Therefore, an entity would not recognise a day one gain or loss for a financial instrument unless its fair value is evidenced by a quoted price in an active market for an identical asset or liability or is based on a valuation technique that uses only data from observable markets.

In determining whether fair value at initial recognition equals the transaction price, an entity considers factors specific to the transaction and the asset or liability. Generally, the transaction price is the best evidence of the fair value of an asset or liability at initial recognition except where (para B4 of Application Guidance):

(a) the transaction is between related parties;
(b) the transaction takes place under duress, such as liquidation;
(c) the unit of account for the transaction price is different from the unit of account for the asset or liability being measured at fair value. For example, if the asset or liability measured at fair value is only one of the elements in the transaction (as in a business combination), the transaction includes unstated rights and privileges that are measured separately in accordance with another HKFRS, or the transaction price includes transaction costs;
(d) the market in which the transaction is executed is different from the principal (or most advantageous) market. For example, markets will be different where a dealer enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers within the dealer market.

§17-800 Disclosures

The objectives of the disclosures are to provide information that enables the users of financial statements to assess the methods and inputs used to develop
fair value measurements and, for recurring fair value measurements that use significant unobservable (Level 3) inputs, the effect of the measurements on profit or loss or other comprehensive income (para 91).

To meet these objectives, an entity provides certain minimum disclosures for each class of asset and/or liability. For non-financial assets and non-financial liabilities measured at fair value (or included at fair value in the statement of financial position), an entity is required to prepare disclosures similar to the existing fair value disclosures for financial assets and financial liabilities in HKFRS 7. This disclosure is also required for non-recurring fair value measurements, e.g. an asset held for sale.

The requirement to disclose a fair value hierarchy and information on valuation techniques extends to assets and liabilities that are not measured at fair value in the statement of financial position but for which fair value is disclosed pursuant to another HKFRS. For example, if an entity uses an asset in a way that differs from the highest and best use of the asset, the entity should disclose the reasons why the asset is used in such a manner.

In addition, an entity should disclose a description of the valuation processes used for measurements categorised within Level 3. This would include how an entity decides its valuation policies and procedures and how it analyses changes in fair value measurements from period to period. An entity discloses a narrative description of the sensitivity of Level 3 measurements to changes in unobservable inputs, including the effect of any interrelationships between unobservable inputs, as well as quantitative information on significant unobservable inputs used in measuring fair value.

For financial instruments, fair value disclosures required in annual financial statements also apply for interim financial reports. For non-financial assets and non-financial liabilities, no additional fair value disclosure requirements are required beyond the existing requirements in HKAS 34 “Interim Financial Reporting”.

HKFRS 13 requires disclosure of accounting policy choice elections in relation to:

(a) the timing of transfers between levels in the hierarchy (para 95); and

(b) the decision to apply (or not to apply) the exception in para 48 in relation to measuring a group of financial assets and financial liabilities with offsetting risk positions (para 96).

An entity would also disclose the existence of any embedded third-party credit enhancements issued with a liability and if such credit enhancement is reflected in the fair value measurement of the liability (para 98).

The presentation of the quantitative disclosures required by HKFRS 13 should be in a tabular format unless another format is more appropriate (para 99).
Illustration 17.5 (Disclosure example — sensitivity to changes in unobservable inputs)

The significant unobservable inputs used in the fair value measurement of our cattle and sheep are growth rates and mortality rates. We have included input factors for growth and mortality of 6% and 3%, respectively. Significant decreases in growth rates, or increases in mortality rates, would result in a significantly lower fair value measurement. Generally, a change in one of these assumptions will tend to cause a movement in the same direction of the other assumption. We have estimated that a 2% increase in the growth rate would increase the mortality rate by 1%.

Illustration 17.6 (Disclosure example — assets not used as highest and best value)

We operate a factory on a 1,000 sq metre piece of land in an area that has recently been re-zoned to allow both residential and industrial use. The highest and best use of the land and buildings, based on current land prices, would be to demolish the factory and build residential property. We are using the land and buildings in a manner that differs from its highest and best use in order to continue our current manufacturing operations. This is consistent with and integral to our long-term strategy and core operations. We do not intend to convert these operations in the foreseeable future.

HKFRS 13 Illustrative Examples contains several hypothetical situations which demonstrate the breadth and depth of judgment required when applying HKFRS 13. Although some aspects within the examples may be present in an actual scenario, entities must consider all relevant facts and circumstances when applying HKFRS 13 to specific cases. These examples can be obtained from www.hkicpa.org.hk.

¶17-950 Comparison with International Financial Reporting Standards

HKFRS 13 is based on IFRS 13 “Fair Value Measurement”. There are no major textual differences between HKFRS 13 and IFRS 13. Compliance with HKFRS 13 will ensure compliance with IFRS 13.