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Need to know

Amendments to FRS 102: New Section 2A *Fair Value Measurement*

Contents

This Need to Know provides an overview of the new Section 2A of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* issued in March 2024 as part of the Financial Reporting Council (FRC)'s periodic review of the UK financial reporting framework.

- Section 2A provides a single framework for measuring fair value where that is required by other Sections of FRS 102. Section 2A is based on the requirements of IFRS 13 *Fair value measurement* and replaces the fair value measurement requirements in the previous appendix to Section 2 *Concepts and Pervasive Principles*
- The amended definition of fair value for liabilities is based on the amount at which a liability is transferred rather than settled. Under the amended definition, the fair value of a liability will need to include the effects of 'own credit risk' (i.e. the risk an entity will fail to discharge its own obligation)
- Unlike IFRS 13, Section 2A does not contain any disclosure requirements and the existing disclosure requirements in relation to fair value in other Sections of FRS 102 have not been amended
- The periodic review amendments are effective for periods beginning on or after 1 January 2026, with early adoption permitted provided that all amendments are applied at the same time (for an overview of all the amendments made to FRS 102 as a result of the periodic review see Need to Know – Amendments to FRS 102 – Periodic review 2024)
- Section 2A should be applied prospectively from the beginning of the reporting period in which an entity first applies the amendments.

Scope

Section 2A *Fair Value Measurement* provides guidance on *how* fair value should be measured. However, Section 2A does not cover *when* fair value measurement should be used but rather applies when another Section of FRS 102 either requires or permits fair value measurement. For example, whether a financial instrument is required to be measured at fair value at the end of each reporting period depends on the classification and measurement requirements of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues.*

Section 2A applies to all transactions and balances (whether financial or non-financial) for which FRS 102 requires or permits fair value measurement, with the exception of share-based payment transactions accounted for under Section 26 *Share-based Payment* and leasing transactions within the scope of Section 20 *Leases.*

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Section 2A also makes it clear that measurements that have some similarities to fair value but that are not fair value are not within its scope. Examples of measurements that have some similarities to fair value but are not fair value include net realisable value under Section 13 *Inventories*, value in use under Section 27 *Impairment of Assets* or the present value of future payments discounted at a market rate of interest for similar debt instruments in Section 11.

Definition of 'fair value'

FRS 102 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". This is commonly referred to as an 'exit price'.

> **Observation**
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> The amended definition of fair value for liabilities is based on the amount at which a liability is transferred, whereas the previous definition was based on the amount at which a liability is settled. Under the amended definition, the fair value of a liability will need to include the effects of 'own credit risk' (i.e. the risk an entity will fail to discharge its own obligation), which will be a change for some entities.
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> Under the previous definition of fair value, it had been argued by some that the effects of 'own credit risk' did not need to be included in the fair value of a liability on the basis that settlement was a transaction solely with the counterparty to the liability who would not consider changes in the entity's credit risk when determining a settlement amount. However, the transfer of a liability would consider all factors a market participant would consider in determining a price which would include the entity's credit risk.

Measurement

In order to measure fair value under Section 2A, an entity will need to consider all of the following:

- the asset or liability being measured (i.e. the unit of account)
- for a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets or on a stand-alone basis (see application to non-financial assets section below)
- the principal (or most advantageous) market in which an orderly transaction would take place for the asset or liability
- the assumptions that market participants would use when pricing the asset or liability.

The asset or liability being measured

The asset or liability being measured at fair value may be (1) a stand-alone asset or liability (e.g. an investment property), (2) a group of assets or a group of liabilities, or (3) a group of assets and liabilities (e.g. a cash-generating unit).

The level at which fair value is measured will depend on the 'unit of account'. As explained in the revised Section 2, a unit of account is selected for an asset or liability when considering how recognition criteria and measurement concepts will apply to that asset or liability and to the related income and expenses. In some circumstances, it may be appropriate to select one unit of account for recognition and a different unit of account for measurement. For example, contracts may sometimes be recognised individually but measured as part of a portfolio of contracts.

> **Observation**
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> In practice, the unit of account will be determined in accordance with the Section of FRS 102 that requires or permits fair value measurement unless there is a clear rationale for using an alternative unit of account for measurement purposes. An example of where an alternative unit of account for measurement purposes may be appropriate is a portfolio of derivative assets and liabilities managed by the entity as a group on the basis of its net exposure to counterparty credit risk.

Principal (or most advantageous) market

Fair value is the price that would be achieved if an asset were sold (or liability transferred) to a market participant in the principal market (i.e. the market with the greatest volume and level of activity for that asset or liability). If there is no principal market, the price in the most advantageous market (i.e. the market in which the entity could achieve the most beneficial price) is used.

In the absence of evidence to the contrary, the market in which the entity normally transacts would be presumed to be the principal or most advantageous market. If location is a characteristic of an asset, the price should be adjusted for costs that would be incurred to transport the asset to the principal (or most advantageous) market. However, other transaction costs would not be included in a fair value measurement because such costs are not a characteristic of the asset or liability.

Application to non-financial assets (highest and best use)

The fair value of a non-financial asset is measured on the basis of the highest and best use of the asset by a market participant. In determining the highest and best use, an entity must contemplate whether the use of the asset is "physically possible, legally permissible, and financially feasible". Unless market or other factors suggest otherwise, an entity's current use of a non-financial asset is presumed to be its highest and best use.

Some entities may purposefully decide not to employ an asset at its highest and best use (e.g. when an entity holds an asset defensively to prevent others from using it). In such circumstances, Section 2A requires measurement based on the highest and best use.

In circumstances in which the highest and best use of an asset is in combination with an asset group (e.g. a business) but the unit of account is the individual asset, the fair value of that asset would be measured under the assumption that a market participant has, or can obtain, the complementary assets or liabilities.

Application to liabilities

The fair value of a liability is determined under the assumption that the instrument would be transferred on the measurement date, but that it would remain outstanding (i.e. it is a transfer value, not an extinguishment or settlement cost). The fair value of a liability must take account of non-performance risk, including the entity's own credit risk. Non-performance risk is assumed to be the same before and after the transfer of the liability.

Valuation techniques

When transactions are directly observable in a market, the determination of fair value can be relatively straightforward, but when they are not, a valuation technique is used.

Section 2A describes three valuation techniques an entity might use to determine the fair value:

- **Market approach** – An entity determines a value that uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business.
- **Cost approach** – An entity determines a value that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
- **Income approach** – An entity determines a value that reflects expectations of future performance.

Entities should use valuation techniques that are appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising inputs that reference an active market. The best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market at the measurement date.

Once selected, a valuation technique should be applied consistently, unless change in valuation technique or its application results in a measurement that is equally or more representative of fair value in the circumstance.

Reliable measure of fair value

Section 2A precludes measurement at fair value if it is not reliably measurable (when the range of reasonable fair value measures is significant and the probabilities of the various measures within the range cannot be reasonable assessed). Such items are measured at cost less impairment until a reliable measure of fair value becomes available. Where a reliable measure of fair value ceases to be available, the items carrying amount becomes its new cost.

Observation

The requirements of Section 2A in respect of when fair value may not be reliably measurable were carried across with minimal changes from the previous appendix to Section 2. As a result, no changes in this area are anticipated on adoption of new Section 2A.

Disclosure

Section 2A does not contain any disclosure requirements. The existing disclosure requirements in relation to fair value in other Sections of FRS 102 have not been amended and continue to apply.

Effective date and transition

The effective date for the amendments is periods beginning on or after 1 January 2026, with early adoption permitted provided that all remaining amendments are applied at the same time. As an exception to retrospective application, Section 2A should be applied prospectively from the beginning of the reporting period in which an entity first applies the amendments.

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