Practical Workshop for NBU Staff

Fair Value measurement IFRS 13

CFRR
Centre for Financial Reporting Reform

WORLD BANK GROUP
Governance

STAREP
Strengthening Auditing and Reporting in the Countries of the Eastern Partnership

STAREP is supported with funding provided in part by European Union, Austria's Federal Ministry of Finance, Austrian Development Cooperation, Luxembourg's Ministry of Finance, SECO - State Secretariat for Economic Affairs

Natalie Manuilova

Senior Financial Management Specialist, CFRR,
the World Bank

November 17, 2015

Why?

- Fair value: a measurement attribute present in many standards
- Required or permitted for measurement and disclosure
- IFRS 13 does not prescribe when fair value may or shall be used
- Effective from January 1, 2013.
- Converged with the US GAAP

Scope of IFRS 13

- Applies whenever Fair Value is required or permitted, except:
  - Share based payments (IFRS 2)
  - Leases (IAS 17)
  - Inventories (IAS 2) (net realisable value)
- Sometimes used with a qualifier: fair value less cost to sell

Before IFRS 13–dispersed and conflicting guidance

IAS 36 | IAS 39/IFRS 9 | IAS 40 | IAS 41 | Etc.

Topic 820 in US GAAP (codified SFAS 157)

IFRS 13

- Single source of measurement guidance
- Clear measurement objective
- Consistent and transparent disclosures about fair value

Examples of the use of fair value (Measurement)

- 1. Revaluation of PP&E and intangible assets (IAS16, IAS 38)
- 2. Investment Properties (IAS 40)
- 3. Agriculture (IAS 41)
- 4. Assets and liabilities acquired in a business combination (IFRS 3)
- 5. In IAS 36: Recoverable amount: higher of value in use or fair value.
- 6. Assets held for sale (IFRS 5): lower of carrying amount and fair value less cost to sell

Examples of the use of fair value

- Examples of use of fair value:
  - Financial instruments held for trading
  - Financial instruments designated as FVTPL or FVTOCI
  - Equity instruments
  - Variations of FV impact P&L or OCI.

When does IFRS 13 apply?

For example, if you own a biological asset…

IAS 41

A biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less cost to sell

What and when

IFRS 13

How

Fair value

- Fair value is a market based measurement, not entity specific
- It is an exit price, i.e.: “price at which an asset could be sold or a liability settled between market participants under current market conditions”
- Intention to sell or to hold not relevant

IFRS 13's 'new' definition of fair value

New fair value definition	Comments
… 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	It specifies that the entity is selling the asset
	It refers to the transfer of a liability
	It is not a forced or distressed sale
	It is clear it is market-based
	It states explicitly when the sale or transfer takes place

Asset or liability to be measured

- Condition, location, restrictions
- Stand-alone or Groups, e.g. CGU's
- Transaction assumed on the principal or the most advantageous market accessible at measurement date

Market participants

- Measurement should use the assumptions a market participant would use, in his best interest
- No use identifying specific market participants, but general characteristics.

Price

- Not adjusted for transaction costs.
- Transaction costs do not include transport costs.
- For non- financial assets, “highest and best use” assumed.
- HBU: Stand-alone or in combination.

Liabilities & entity's own equity

- Instrument assumed to be transferred to a market participant at measurement date.
- No settlement or extinguishment.
- If held by other parties as assets, use quoted price or a technique maximising observable inputs

Liabilities & entity's own equity (continued)

- If not held by another party as assets
- Use a valuation technique from the perspective of a market participant owing the liability or claiming for the equity.
- Take account of non performance risk, including own credit risk

Liabilities & entity's own equity (continued)

- Effect of a transfer restriction: No additional input added.
- Financial liability with a demand feature.
- No less than the amount payable on demand

Offsetting positions

- Entity holding a group of financial assets and liabilities exposed to market risk or credit risk, may if it manages on net exposure, measure the fair value on the basis of the net exposure.
- This exception does not pertain to financial statement presentation.

Fair Value at initial recognition

- Entry price may sometimes differ from FV, an exit price.
- If FV on initial recognition, difference with entry price recognised in P&L, unless otherwise required.

Valuation techniques

- Maximizing the use of relevant observable inputs (minimizing unobservable)
- Objective: always to arrive at a price with market participants would arrive at.
- Market approach, cost approach, income approach.

Fair Value hierarchy

- Three levels, 1 to 3 as the use of observable inputs decreases.
- Level 1 inputs:
  - Quoted prices (unadjusted) in active markets for identical assets and liabilities that entity can access at measurement date.
  - Principal (most advantageous) market

Fair Value hierarchy (continued)

- Level 2 inputs:
  - Inputs other than quoted prices in level 1, observable, directly or indirectly, e.g.: quoted prices for similar assets or liabilities on active markets; quoted prices for identical assets on markets not active, other inputs observable: interest rates, yield curves, volatility, spreads.

Fair Value hierarchy (continued)

- Level 3 inputs:
  - Unobservable inputs
  - Little or no market activity; but same objective maintained.
  - Use best information available, including entity's own data.

Selecting a valuation approach

	Market approach Market price is available	Income approach (eg discounted cash flow)	Cost approach (eg replacement cost)
Level 1	• Price for identical item • Must be used without adjustment	• Directly identifiable cash flows	• Not directly income-producing • No identical market price • Price needs adjustment
Level 2	• Price needs adjustment • Observable inputs	• Observable inputs • Rare	• Observable inputs • Rare
Level 3	• Price needs adjustment • Unobservable inputs	• Unobservable inputs	• Unobservable inputs

Valuation approaches and techniques

Valuation approaches	Valuation techniques
Market approach	- Transaction price paid for an identical or a similar instrument of an investee - Comparable company valuation multiples
Income approach	- Discounted cash flow (DCF) method - Dividend discount model (DDM) - Constant-growth DDM - Capitalisation model
A combination of approaches may be used	- Adjusted net asset method

Market approach

- Uses prices and other relevant information that have been generated by market transactions that involve identical or comparable assets.
- Techniques that are most commonly referred to for valuing unquoted equity instruments are related to the data sources that they use:
  - transaction price paid for an identical or a similar instrument of an investee
  - comparable company valuation multiples derived from quoted prices (i.e. trading multiples) or from prices paid in transactions such as mergers and acquisitions (i.e. transaction multiples)

Valuation multiples

Valuation basis:

Equity value

Enterprise value (EV)

Multiple $= \dfrac{Equity\ value\ or\ Enterprise\ Value\ (EV)}{Performance\ measure}$

Performance measures:

EBITDA, EBIT, EBITA

Earnings, ie net income (E)

Book value, ie value of an entity's shareholders equity (B)

Fair value measurement using valuation multiples

- Four steps:
  - Identify comparable company peers.
  - Select the performance measure that is most relevant to assessing the value for the investee.
  - Apply the appropriate valuation multiple to the relevant performance measure of the investee to obtain an indicated fair value of the investee's equity value or the investee's enterprise value.
  - Make appropriate adjustments to ensure comparability (e.g. non-controlling interest discount).

Commonly used valuation multiples

Earnings multiples commonly used when valuing: established business with an identifiable stream of continuing and stable earnings:

$EV/EBITDA, EV/EBIT, EV/EBITA$

P/E (where P is entity's market capitalisation)

Book value multiples: where entities use their equity capital bases to generate earnings (eg businesses that have not yet generated positive earnings)

P/B

Revenue multiples: $EV/Revenue$

Portfolios of financial instruments

- IFRS 13 permits an entity to measure a group of financial assets and financial liabilities on the basis of the net risk exposure to either market risks or credit risks.
- This practice was already allowed in IAS 39/IFRS 9
- The “exception” was permitted because:
  - derivatives often cannot be sold, but management can mitigate risk exposure by entering into an offsetting position
  - portfolio composition is entity-specific (depends on entity’s risk preferences)

Portfolios of financial instruments (continued)

- Conditions that need to be met:
  - Entity must have documented risk management strategy
  - The entity provides information on the basis of the net risk exposure to key management personnel
- Only for portfolios of instruments measured at FV
- Accounting policy decision
- Does not affect presentation in IAS 32.
- Allocations shall be performed on a reasonable and consistent basis.
- Portfolio-level adjustments may need to be allocated to the unit of account for presentation purposes.

Portfolios of financial instruments (continued)

- If there are offsetting market risks:
  - can apply bid-ask spread to net open risk position
  - offsetting risks must be “substantially the same”
  - duration of instruments leading to exposure to market risk must be “substantially the same”

Market risk: the risk that the price will fluctuate because of changes in market prices (currency risk, interest rate risk and other price risk).

Portfolios of financial instruments (continued)

- If the entity is exposed to the credit risk of a particular counterparty, an entity shall include the effect of:
  - its net exposure to the credit risk of the counterparty.
  - the counterparty's net exposure to its credit risk.
  - any existing arrangements that mitigate credit risk exposure if market participants expect that such arrangements would be legally enforceable in the event of default.

Credit risk: the risk the entity or the counterparty will not pay or otherwise perform as agreed.

IFRS 13 Disclosure

- Many detailed disclosures, including:
- Levels in the hierarchy: 1,2,3
- Transfers between levels and reasons thereof
- Description of valuation techniques and inputs used for levels 2 & 3

IFRS 13 Disclosure (continued)

- Many detailed disclosures on Level 3
- Impacts of level 3 on profit & loss.
- Sensitivity of FV measurements (L3) to changes in unobservable inputs.
- Determining appropriate classes.
- Policies for transfers between levels
- Tabular format suggested.