Fair Value for Financial Reporting

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Fair Value Framework

- IFRS 13 Fair Value Measurement
- Establish a common definition for a market-based, not entity-specific, definition.
  - “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”

Fair Value Framework

- Fair Value is a market-based exit price.
- Fits with the IFRS definitions of assets and liabilities:
  - Assets result in cash inflows
  - Liabilities result in cash outflows
- Entities recognize and measure assets and liabilities.
- Eliminate the willing seller notions

Fair Value Framework

- Introduces a six-stage Fair Value framework:
  - Determine Unit of Account
  - Evaluate Valuation Premise
  - Assess the Principal Market
  - Establish Most Advantageous Market
  - Select Valuation Methods
  - Estimate Fair Value

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STAGE 1 - DETERMINE UNIT OF ACCOUNT

Stage 1 - Determine Unit of Account

- What is actually being valued?
- A stand-alone item, a group of related items such as an operating plant, a business, a technology or even a liability:
  - Loan portfolio (Financial Asset)
  - Office building (Physical Asset)
  - Operating plant (Physical Asset)
  - Brand (Intangible Asset)
  - Single publicly traded share (Financial)
  - Reporting or cash generating unit (Financial)

Stage 1 - Determine Unit of Account

- Value is based on the level of aggregation or disaggregation in applicable IFRS.
- Must reflect the item’s characteristics:
  - Condition
  - Location
  - Restrictions on sale or use

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STAGE 2 – EVALUATE VALUATION PREMISE

Stage 2 – Evaluate Valuation Premise

- Physical and Intangible Assets are based on the highest and best use by market participants.
- May differ from management’s intentions or even existing use:
  - A restaurant is the highest and best use considered by market participants to be a parking lot – that establishes Fair Value.

Stage 2 – Evaluate Valuation Premise

- Highest and best use of an item:

<u>In-combination</u>

- Physical or intangible asset provides maximum value to market participants principally as part of a group of assets.
- Even when in combination, Fair Value is still market-based considering facts and circumstances.

Stage 2 – Evaluate Valuation Premise

- May apply to a single unit of account, such as a reporting or cash generating unit, if the underlying items are used together.
- Applies when combining multiple units.

Stand Alone

- Provides maximum value principally as an individual unit.

Stage 2 – Evaluate Valuation Premise

Market Participants

- Concept is a key element of Fair Value ensuring it is market based not entity specific.
- Similar to but not the same as the willing buyers and willing sellers of Fair Market Value.

Stage 2 – Evaluate Valuation Premise

- Buyers and sellers in the relevant markets that are:
  - Independent of the entity and each other.
  - Knowledgeable with a reasonable understanding of the item and transaction using all available information including usual and customary due diligence.
  - Able to enter into a hypothetical sale.
  - Willing to deal – motivated but not forced or otherwise compelled.

Stage 2 – Evaluate Valuation Premise

- In identifying candidates management should consider factors specific to the item, the market and entities with whom the firm would transact.
- Profile potential candidates.
- Specific entities need not be identified.
- Usually the process is straightforward due to general knowledge of potential buyers.

Stage 2 – Evaluate Valuation Premise

- Sometimes management must make assumptions about the type of market participant that might be interested.
- With the exit market determined, market participants' assumptions for each valuation premise are developed.
- Interaction between the valuation premise and the appropriate market is iterative.

Stage 2 – Evaluate Valuation Premise

Unit of Account & Valuation Premise

- Unit of account is what is being valued.
- Individual units of account may be aggregated to achieve highest and best use.
- Groupings, from market participants' perspectives reflect an entity's access to the market.
- A single unit of account can be included in only one group.

Stage 2 – Evaluate Valuation Premise

Existing Form

- Item is valued in current condition.
- Transformation or value adding activity is deducted.
- When applying aggregation and disaggregation the ultimate valuation must relate solely to the unit of account.

Stage 2 – Evaluate Valuation Premise

Highest and Best Use

- Applies to Physical and Intangible Assets
- Gives greatest return for Market Participants and is:
  - Physically possible
  - Legally permissible
  - Financially feasible

Stage 2 – Evaluate Valuation Premise

<u>Physically possible</u>

- Account for characteristics that market participants would consider when pricing the asset – location, condition of a fleet.

<u>Legally permissible</u>

- Accounts for restrictions that market participants would consider when pricing the asset - zoning regulations applicable to a property.

Stage 2 – Evaluate Valuation Premise

Financially Feasible

- Account for the return (income or cash flow) market participants would require considering the costs of converting the asset to that use.
- Highest and Best Use is determined from market participants perspective even if the entity intends a different one.
- The existing use is presumed to be the highest and best unless market or other factors suggest a different one by market participants would maximize its value.

Stage 2 – Evaluate Valuation Premise

Defensive Assets

- An entity may intend to not actively use an asset according to its highest and best use to protect its competitive position.
- It may aim to prevent others from using it.
- Fair Value is still determined by its highest and best use by market participants.

Stage 3 - Assess the Principal Market

- Depending on facts and circumstances, it may be reasonable to incorporate assumptions and input a market price by working backward from a downstream outcome.
- Determine potential markets, their participants and valuation premises
- Consider which are accessible.
- Assume the principal market is the most advantageous with no opposing evidence.

STAGE 3 - ASSESS THE PRINCIPAL MARKET

Stage 3 - Assess the Principal Market

- A valuator may need to estimate prices in multiple markets and consider all valuation premises.
- If there is a principal market stages three and four can be expedited.
- Principal market is that representing a majority of the traded volumes.
- Potentially more advantageous markets cannot be incorporated into Fair Value when there is a principal market.

Stage 3 - Assess the Principal Market

- If an entity regularly buys or sells a particular item in a single market that is the one.
- Usually it is the most advantageous.
- Continuous evaluation of multiple prices and markets is not necessary to determine the most advantageous.

Stage 3 - Assess the Principal Market

Market Selection

- The principal or most advantageous market is determined from the perspective of the entity to allow for those with more than one activity.
- An entity's different cash generating units may transact in different markets.
- Each unit individually considers its markets.

Stage 3 - Assess the Principal Market

- Not all entities have access to the same markets.
- Items sold in a number of them.
- Different markets have different prices.
- Participants in each vary.
- Inaccessible markets may be considered in a hypothetical transaction but are not a principal or most advantageous market.

STAGE 4 –MOST ADVANTAGEOUS MARKET

Stage 4 –Most Advantageous Market

- A single entity can have several Fair Values for identical or similar items depending on the relevant units and their markets.
- Each considers the appropriate facts and circumstances following the Framework, irrespective of another unit's holdings of identical or similar items

Stage 4 –Most Advantageous Market

Transaction and Transportation Costs

- Prices are not adjusted for transaction costs - those are not attributes, merely incremental specific expenses, that differ by nature.
- Considered in assessing net proceeds for the most advantageous market.
- Location is a characteristic of an item (such as inventory) therefore Fair Value includes transportation costs.
- Delivering a physical item to market is part of establishing Fair Value.

Stage 4 –Most Advantageous Market

No apparent exit market

- Determine the characteristics of hypothetically buyers - strategic or financial.
- Identify assumptions they use to price the item.
- Construct a notional market based on the entity’s assumptions about what buyers take into account negotiating a purchase.
- Key considerations are specific location, condition, assumed market growth, expected depreciation, availability of certain synergies and appropriate risk premium.

Stage 4 Example – Market Selection

- Ascendo Limited identifies that a certain item of equipment is impaired.
- The charge depends on its Fair Value.
- Identical items sold in three markets: retail wholesale or auction.
- None is the principal market because it does not regularly trade in equipment.

Stage 4 Example – Market Selection

- As there is no principal market Fair Value is based on the most advantageous.
- The one with the highest net proceeds.

	Retail	Wholesale	Auction
	$	$	$
Price	10,000	9,700	9,500
Transportation Costs	(200)	(300)	(150)
Fair Value	9,800	9,400	9,350
Transaction Costs	(500)	nil	(450)
Net Proceeds	9,300	9,400	8,900

Stage 4 Example – Market Selection

- Fair Value then is the wholesale (most advantageous) market figure.
- Different transaction costs change the conclusion.

	Retail	Wholesale	Auction
	$	$	$
Fair Value	9,800	9,400	9,350
Transaction Costs	(300)	-	(200)
Net Proceeds	9,500	9,400	9,150

Stage 4 Example – Market Selection

- Here the most advantageous market is the retail.
- It yields the highest net proceeds ($9,500).
- Fair Value is now $9,800 not $9,400.

STAGE 5 – SELECT VALUATION METHODS

Stage 5 – Select Valuation Methods

- Use any method under one of the three standard valuation approaches – market, income and cost (asset).
- Consider them all.
- Select methods where market participants' assumptions can be obtained without undue cost and effort.

Stage 5 – Select Valuation Methods

Market Approach

- Prices and other relevant information from market transactions involving identical or similar items, such as business interests.
- Ranges of market multiples, such as Price Earnings Ratios (PER) derived from comparables.
- Select appropriate level within the range based on qualitative and quantitative factors to the situation.
- Matrix pricing is commonly used to price liabilities (as assets) by relying on their relationships (spreads) to quoted (benchmark) prices.

Stage 5 – Select Valuation Methods

Intangible Assets

- Usually no exit market.
- Normally no market participants.
- Can rarely use Market Approach.
- Exceptions such as taxi licenses.
- Selling price to market participants does not work.
- MUST apply Income or Cost Approach whichever is more suitable.

Stage 5 – Select Valuation Methods

- Choose theoretical market participants - strategic or financial buyers.
- Valuator picks the most likely strategic – which usually pay more.
- When the auditor questions the decision - how do we prove it is correct?

Stage 5 – Select Valuation Methods

- We cannot prove that a strategic buyer is the most logical market participant nor can the auditor demonstrate the opposite.
- The auditor will likely be conservative, choose a financial buyer that pays less with lower goodwill.
- There will be trouble and arguments.

THE AUDITOR ALWAYS WINS.

Stage 5 – Select Valuation Methods

Income Approach

- Converts future amounts (cash flows or earnings) for either the next year (capitalization) or a projected period (discounting) to a single value.
- Indicates market participants current expectations about future activities.
- Includes present value techniques and option pricing models as well as multi-period excess earnings.
- Use the method appropriate to the specific facts and circumstances.

Stage 5 – Select Valuation Methods

Discounted Cash Flows

- Key method from the perspective of market participants.
- Requires supportable:
  - Projections of future cash flows.
  - Scenarios for different expectations of possible variations in amount and timing.

Stage 5 – Select Valuation Methods

Discount Rate

- Based on risk-free rates for same durations as cash flows.
- Add risk premiums to:
  - Nature of item (may be more than equity risk)
  - Industry features
  - Specific entity characteristics
  - Other factors considered by market participants

Stage 5 – Select Valuation Methods

Incorporating Risks in Cash Flows

- Adjustments reflecting systematic (non-diversifiable) risk can be made to the projected cash flows or the discount rate.
- Adjusting expected cash flows to reflect systematic risk is very difficult.
- Discount rate applied to cash flows is often the weighted-average cost of capital required by a marketplace participant.
- Option pricing models are part of this approach.

Stage 5 – Select Valuation Methods

Cost Approach

- Based on the amount that currently required to replace the service capacity of an item (current replacement cost).
- Assumes Fair Value does not exceed what a market participant would pay to acquire or construct a substitute item of comparable utility, adjusted for condition.

Stage 5 – Select Valuation Methods

- Requires estimating deductions for:
  - Functional Deterioration: The loss in value resulting from a relative inability of the asset to fulfill its intended purpose.
  - Technological Obsolescence: Occurs when a new process is introduced that significantly lowers operating expenses or improves quality.

Stage 5 – Select Valuation Methods

- Physical Decline: Reflects that for older equipment, even when well maintained and retaining full functionality, spare parts and trained technicians may be difficult and expensive to obtain.
- Economic Deprivation: Drop-offs due to economic or market factors.

- Replacement cost method includes product improvements and new materials.

Stage 5 – Select Valuation Methods

Application of Valuation Techniques

- The Framework does not prescribe which valuation techniques should be used nor does it prioritize among them.
- Those chosen should be appropriate in the circumstances.
- Choice is affected by the availability of relevant inputs and their relative reliability.

Stage 5 – Select Valuation Methods

- In some cases one method may provide the best indication of Fair Value.
- In most circumstances several are desirable.
- When reconciling them frequently one or more are less relevant as a result of limited data or the type of asset.
- Due to underlying assumptions all results may not be equally representative of Fair Value.
- When multiple techniques are used evaluate and weigh the results to develop a range of possible conclusions.

Stage 5 – Select Valuation Methods

- Fair Value is the most representative point within that range under the circumstances.
- Techniques for each type of asset should be consistently applied.
- It is appropriate to change them or their application if the new result better represents Fair Value.
- Fair Value revisions, from modifications in techniques or changed applications, are changes in accounting estimates that affect current and future reporting periods.

Stage 5 – Select Valuation Methods

Fair Value Hierarchy

- Three levels of inputs.
- Distinguishes between those observable from market data - more objective - and those unobservable - more subjective.
- Inputs are market participants' assumptions for pricing decisions including measures of risks.

Stage 5 – Select Valuation Methods

- Level 1 Inputs
  - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.
  - Usually financial instruments or homogeneous products.
  - Examples: quoted prices for items that trade frequently in volume on a major exchange or dealer market.

Stage 5 – Select Valuation Methods

- Level 2 Inputs
  - Inputs other than quoted prices included in Level 1 that are directly or indirectly observable.
  - Other semi-uniform items such as automobiles or office equipment.
  - Examples: interest rate and yield curves at commonly quoted intervals, implied volatilities or credit spreads.

Stage 5 – Select Valuation Methods

- Level 3 Inputs
  - Anything unobservable or requiring major adaptation.
  - Examples: projected cash flows of an entity or reported past real estate transactions in a different municipality requiring adjustments for time, size and location.

Stage 5 – Select Valuation Methods

- The lowest significant input determines the position of the entire measurement.
- Assessing the importance of a particular input requires judgment.
- Determining which amounts are based on Level 3 inputs is essential as certain disclosures are only required for them.

Stage 5 – Select Valuation Methods

Subsequent Events

- Fair Value reflects facts and circumstances existing on the specified date as well as events before, or reasonably foreseeable on that date.
- Significant situations (principal transactions, brokered trades or announcements) may occur after the close of a market (say, over a weekend) but before the measurement date.

Stage 5 – Select Valuation Methods

- Confirm they are representative before using.
- Establish and apply a consistent policy for identifying and incorporating such events.
- Measurements using entity adjusted quoted prices are Level 2.

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STAGE 6 - ESTIMATE FAIR VALUE

Stage 6 - Estimate Fair Value

- The use of “blockage discounts” is prohibited for all assets.
- They relate to the size of the holding (shares or automobiles) in relation to the volume of trading in the reference market.
- This forbidden concept is frequently seen in the real world - increased supply reduces prices.
- Therefore price multiplied by quantity equals Fair Value.
- A block purchased at a premium shows a Day One loss.

Stage 6 - Estimate Fair Value

- If unit of account is a complete shareholding any discounts or premiums that market participants might apply are allowed for:
  - Limited voting rights
  - Minority position
  - Lack of marketability (DLOM)
  - Control premium - more for 68% (super majority) than 51%, increases between 80% (tax consolidation in US) and 100%.

Conclusion

- The result of the market determination process and the application of appropriate valuation methods is Fair Value.
- When the conclusion applies to an asset group valued in-combination the total must be allocated to each component based on the specific facts and circumstances.

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- ANY QUESTIONS ?

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