KPMG

Fair value Accounting

Financial reporting quality: is fair value a plus or a minus?

Is It Fair to Blame Fair Value Accounting for the Financial Crisis?

by Robert C. Pozen

Mark-to-Market Accounting: Kill It Before It Eats Us Alive

Fair value accounting is the wrong scapegoat for this crisis

The Decision Usefulness of Fair Value Accounting - A Theoretical Perspective

Working Paper

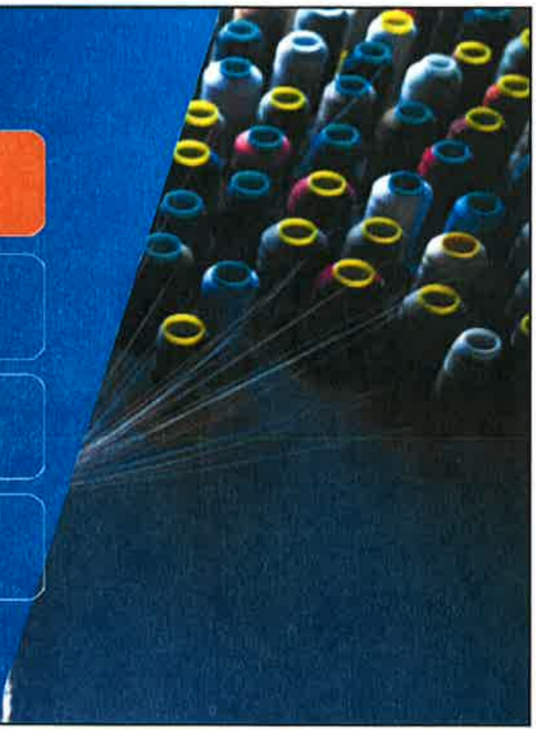
The crisis of fair value accounting: Making sense of the recent debate

We need to kill mark to market accounting before it eats us alive. These accounting rules are like The Blob, an alien life form that consumes everything in its path as it grows and grows. Both the Blob and mark to market accounting crawl, creep and eat everything dead or alive in their path. We need to save ourselves by putting mark to market accounting into deep freeze while there is something left to save.

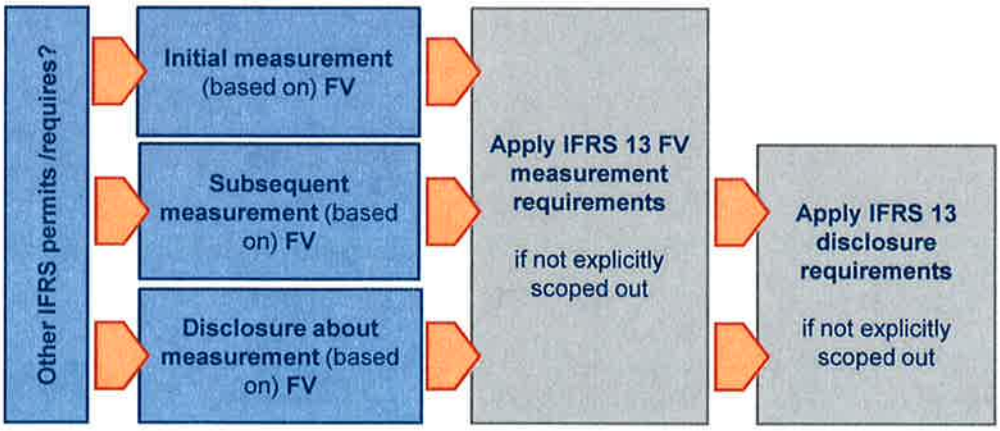
Before I proceed (and get flamed by angry commenters), I want to set the record straight. I believe financial statements should present a conservative, consistent and realistic report of results of operations, financial condition, cash flow and contingent liabilities and assets. Bad assets and poor management decisions should not be hidden behind accounting manipulations. Loan loss and other reserves should be conservatively determined and uncollectable assets should be promptly written off. Accounting rules shouldn't drive business decisions, they should reflect them.

Agenda

1. Introduction and scope
2. Definition of Fair Value
3. Selected Application Issues
4. Disclosures



General IFRS 13 requirements on scope



IFRS 13 – Fair Value Measurement

Framework for HOW, not WHEN

In scope

- Financial instruments
- Assets and liabilities in a business combination
- Impairment, when at fair value less costs of disposal
- Non-current assets held for sale in (IFRS 5)
- Investment property, intangibles, PP&E held at fair value
- Biological assets

Not in scope

- IFRS 2 Share-based Payment
- IAS 17 Leases

Not in scope – disclosures

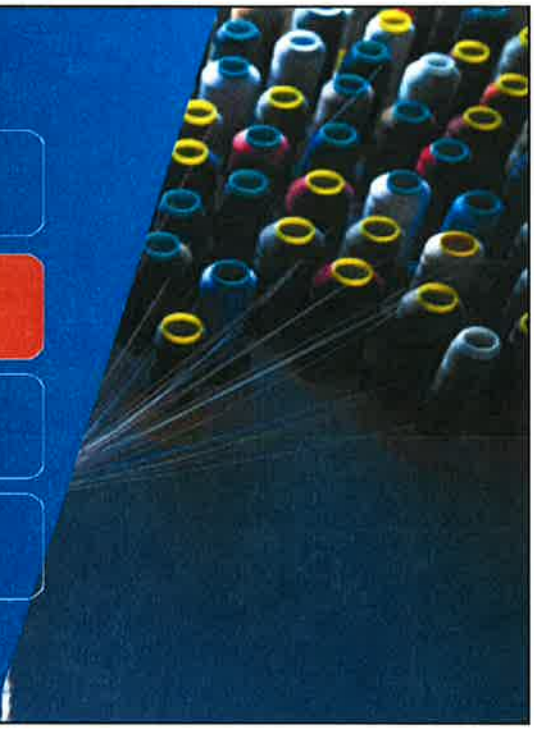
- IAS 19 Employee Benefits
- IAS 26 Retirement Benefit Plans
- IAS 36 Impairment of Assets, when Value in Use

Which of these is in the scope of IFRS 13?

Item	In scope of FV *measurement* requirements	In scope of FV *disclosure* requirements
Interest rate swap		
Loan measured at amortised cost		
Property plant and equipment		
Revenue		
Investment property (cost model)		

Agenda

1. Introduction and scope
2. Definition of Fair Value
3. Selected Application Issues
4. Disclosures



Implications of IFRS 13's FV definition

The amount for which ***an asset could be exchanged, or a liability settled***, between ***knowledgeable, willing parties*** in an arm's length transaction.

Pre IFRS 13

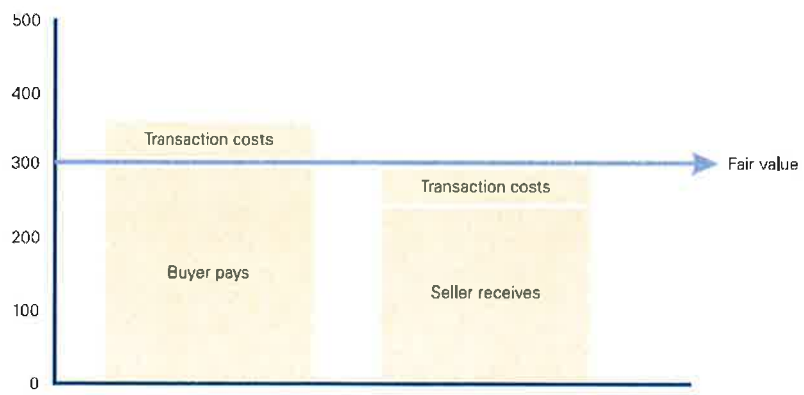
The price that would be received to sell ***an asset or paid to transfer a liability*** in an orderly transaction between ***market participants*** at the ***measurement date.***

IFRS 13

- Exit price notion
- Liabilities: transfer vs settlement
- Market participant vs entity specific measurement
- Measurement date

KPMG

Example – transaction costs excluded from FV



The transaction

Principal market: The market with the greatest volume and level of activity for the asset or liability

Most advantageous market: 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 taking into account transaction costs and transport costs. ONLY used in the absence of a principal market

- Entity must have access to the principal (or most advantageous) market
  - Determined from the entity's perspective, based on ability to access
- Absent evidence to the contrary, the market in which the entity would normally sell the asset or transfer the liability is assumed to be the principal (or most advantageous) market

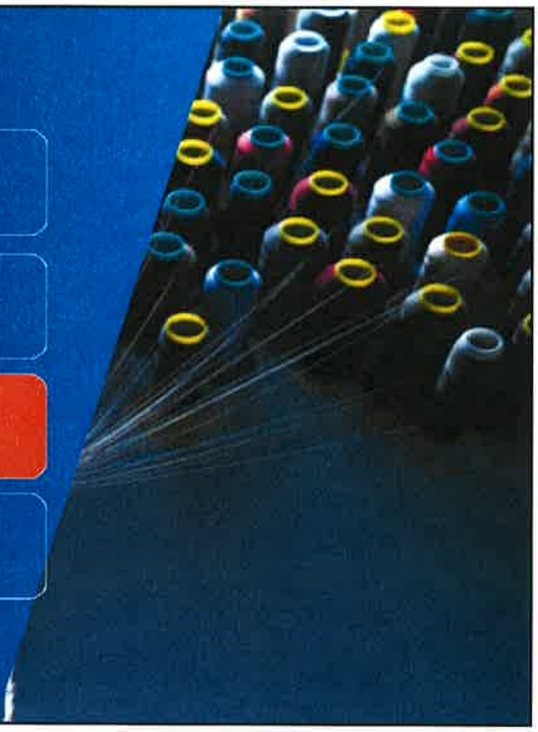
Eksempel - "Principal market or most advantageous market"

Company S holds an asset that is traded in three different markets as follows:

	Marked A	Marked B	Marked C
Volum	30.000	12.000	6.000
Handler pr mnd	30	12	10
Pris	50	48	53
Transportkostnader	(3)	(3)	(4)
Mulig virkelig verdi	47	45	49
Transaksjonskostnader	(1)	(2)	(2)
Netto kontantstrøm	46	43	47

Agenda

1. Introduction and scope
2. Definition of Fair Value
3. Selected Application Issues
4. Disclosures



Måling – egen kredittrisiko

Foretak A har to valutaderivater som de iht standarden skal regnskapsføre til virkelig verdi. Foretaket har hatt betydelig nedgradering mht kredittkvalitet i løpet av de seneste månedene. Vi antar følgende:

Termin	Termin-kurs	Val.kurs 31.12	Oppgitt verdi fra motpart (eks kredittkv)	Beregnet virkelig verdi (inkl kredittkv)
Kjøp 100 EURO	8,50	7,50	-100	-60
Salg 100 USD	7	6,50	50	50
Netto verdi			-50	-10

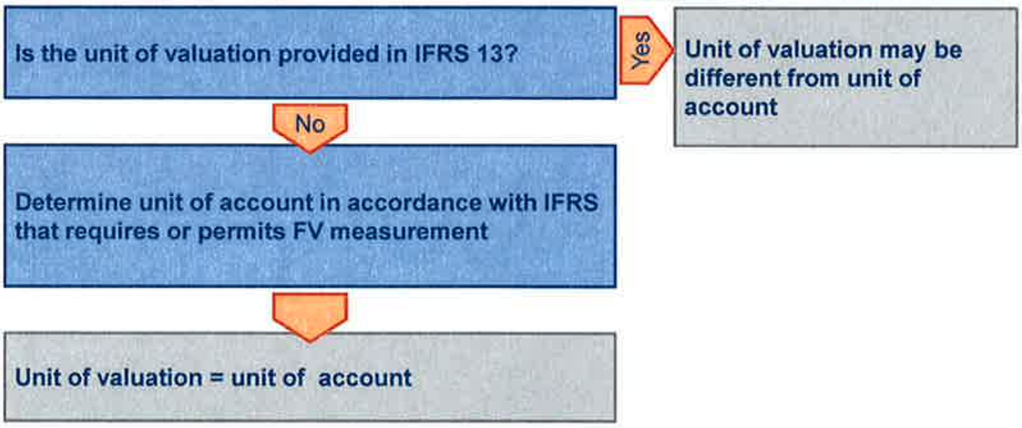
HVA MENER DU ?

Selskapet har "covenantskrav" som vil være brutt hvis "egen kredittrisiko" ikke inkluderes i beregningen av virkelig verdi

Banken hevder at "fair value" tilsier at neddiskontert verdi ekskl egen kredittrisiko skal benyttes

12

Unit of account and unit of valuation



13

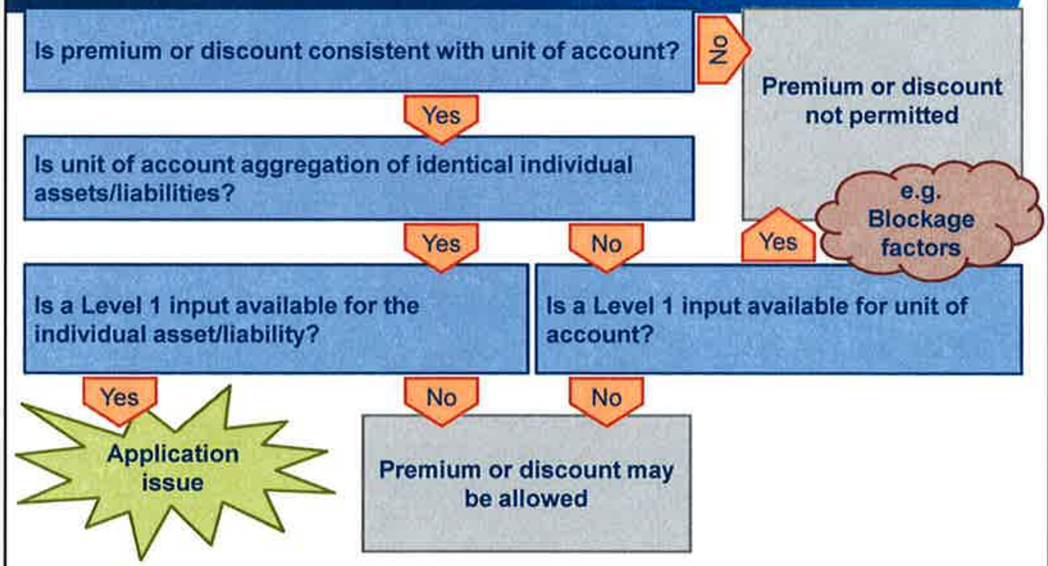
Mini-case 1: Large holding

Fact pattern:

- Entity P holds 8% (i.e. 1.5 million shares) of the share capital in Entity Q.
- Daily trading volume is 1% of outstanding shares.
- The quoted price for one share in Q is CU 10 at the measurement date.
- P assumes that it would be able to sell its 8% stake in one transaction for CU 13.5 million at the measurement date.

Q1a: What is the FV of P's 8% interest in Q at the measurement date if Q's shares are traded in an active market?
Q1b: How would your approach change if the market for Q's shares was inactive?

Premiums, discounts and blockage factors



Mini-case 2: Highest and best use

- An entity acquires in a business combination land that is currently used as a site for a factory
- Recent zoning changes permit residential use of land and some adjacent sites have been developed for residential use
- The highest and best use of the land is determined by comparing:
  - **value based on current use**
    As an industrial property (current use), the values of the land and factory are 300,000 and 140,000 respectively, or 440,000 in total
  - **value as a vacant site** ready for residential development, considering the costs to demolish the factory and prepare the land as a vacant site
    Fair value of this use, after considering costs for demolishing the factory and other conversion costs, is 550,000

Q2: What is the fair value of the land and factory?

Highest and best use of a non-financial asset

Do market or other factors suggest that different use by market participant maximises asset's value?

No → FV is based on asset's **current use.**

Yes ↓

Identify other uses that are physically possible, legally permissible AND financially feasible either on:
- Stand-alone basis; or
- In combination with other assets or assets and liabilities.

↓

Measure FV based on use that maximises the asset's value **= highest and best use.**

KPMG

Mini-case 3: Valuation techniques

- To measure the FV of CGU X, the following valuation techniques are available to Company Z:
  a) EBITDA multiple; multiple is based on EBITDA and enterprise value of listed entities that have businesses similar to CGU X.
  b) Based on the recent sale price for a business similar to CGU X.
  c) Discounted estimated cash flows for the next five years with a terminal value.

Q3: Arrange the valuation techniques in the order of appropriateness for FV measurement purposes.

Fair value hierarchy

- IFRS 13 contains a hierarchy of fair value inputs, the same as introduced by IFRS 7
- The fair value hierarchy prioritises the inputs to valuation techniques used to measure fair value into three levels, considering the relative subjectivity of inputs

Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the reporting date

Level 2 – inputs other than quoted prices included in level 1, that are observable for the asset or liability, either directly or indirectly

Level 3 – unobservable inputs

Valuation techniques, maximise observable inputs

Market approach	Uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities
Income approach	Converts future amounts (e.g. cash flows or income and expenses) to a single present (discounted) amount
Cost approach	Reflects the amount that would currently be required to replace the service capacity of an asset (current replacement cost)

Agenda

1. Introduction and scope
2. Definition of Fair Value
3. Selected Application Issues
4. Disclosures

KPMG

Disclosures

Ref	Requirement	Recurring L1	Recurring L2	Recurring L3	Non-recurring L1	Non-recurring L2	Non-recurring L3	FV disclosed L1	FV disclosed L2	FV disclosed L3
93(a)	Fair value at end of reporting period	■	■	■	■	■	■			
93(a)	Reasons for the measurement				■	■	■			
93(b)	Level within hierarchy	■	■	■	■	■	■	■	■	■
93(c)	Transfers within hierarchy	■	■	■						
93(d)	Description of valuation technique and inputs		■	■		■	■		■	■
93(d)	Any changes to valuation technique and reasons		■	■		■	■		■	■
93(d)	Quantify unobservable inputs			■			■			
93(e)	Reconciliation of opening and closing balance			■						
93(f)	Unrealised gains/losses from remeasurement			■						
93(g)	Description of valuation processes and policies			■			■			
93(h)(i)	Narrative sensitivity to changes in unobservable inputs			■						
93(h)(ii)	Quantitative sensitivity to changes in unobservable inputs (for financial assets and financial liabilities only)			■						
93(i)	If highest and best use differs from actual, then reasons why	■	■	■	■	■	■	■	■	■

■ Disclosure required