The Institute of
Chartered Accountants
of Pakistan

CA PAKISTAN

# Topic wise Selected Opinions

# IFRS 13 - Fair Value Measurement

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## 1. Determination of fair value at the measurement date under IFRS 13, Fair Value Measurement

### Brief facts of the enquiry

The Accounting Standards Board (the Board) received an enquiry about the determination of fair value of unquoted equity instruments under IFRS 13, Fair Value Measurement, in a specific fact pattern. The fact pattern is summarized below:

- A publicly listed company (Company A), in June 2019, made a strategic investment in a start-up company (Company B) by purchasing a specific number of voting and non-voting shares at a mutually agreed purchase price.

- Company A, at the reporting dates of June 30, 2019, June 30, 2020 and December 31, 2020, determined the fair value of its investment in Company B using the services of an independent valuer.

- In June 2021, Company B issued equity shares to an unrelated third party at a price above the fair value determined at previous reporting date (i.e. December 31, 2020).

Along with the above fact pattern, the submission referring to paragraph B 5.4.15 of IFRS 9, Financial Instruments, also noted that after June 2021, there were no significant changes to Company B's performance and products, global economy or the comparable entities. Additionally, there were no indications of fraud or any transfer of any external transactions. In view of above, the submission noted that it would be appropriate to use the most recent transaction price (i.e. price of a share issued in June 2021) as the measurement price as at December 2021, in accordance with IFRS 13.

The enquirer, based on the above understanding, asked whether Company A can measure fair value of its investment in Company B, at the reporting date of December 2021, using the transaction price (per share) in the most recent transaction i.e. price at which Company B issued its shares in June 2021.

### The Accounting Standards Board comments and conclusion

1. The Board noted that in accordance with paragraphs 57-60 of IFRS 13, an entity:

    a) can consider the transaction price for unquoted equity instruments in a recent transaction as a reasonable starting point for measuring the fair value of such instruments at the measurement date;

    b) is also required to assess whether the transaction price in the most recent transaction needs to be adjusted. The adjustment could be owing to the existence of factors noted in paragraph B 5.4.15 of IFRS 9 or if other evidence indicates that the transaction price might not be representative of fair value at the measurement date; and

    c) would need to adjust the most recent transaction price for the aforementioned factors to arrive at the fair value at the measurement date. The nature and amount of adjustment (if any) will depend on the specific facts and circumstances.

2. The Board, based on the fact pattern and above principle-based guidance of IFRS 13, concluded that determination of fair value as well as the consideration of factors that could influence and change the fair value involve exercise of management judgement. Entity's management would be required to apply judgment based on the specific information and circumstances.

3. The Board also considered it pertinent to explain that it considers accounting enquiries and provides clarification on the matters relating to interpretation of the requirements of accounting and reporting standards as applicable in Pakistan. The enquired matter of appropriateness of a particular amount of fair value involves management judgement considering the specific information and circumstances. In the submitted fact pattern, determination of fair value of unquoted equity instruments at the measurement date does not involve interpretation of IFRS 13.

*(September, 2021)*

## 2. Clarification on applicability of International Valuation Standards on fair value measurements done under IFRS 13 Fair Value Measurement

**Enquiry:**

Our company made an investment (accounted for as financial asset at fair value through profit and loss) in a private company (a startup) having an e-commerce related business. In order to determine its fair value at year end, we have done its valuation based on discounted cash flow method as per IFRS 13 Fair Value Measurement.

But one of our senior management personnel objected on this and said it's not an appropriate method of valuation for startup businesses as per International Valuation Standards, as there are no historical cash flows to rely on.

My query is that:

(a) Whether the International Valuation Standards issued by International Valuation Standards Council are adopted by the ICAP; and

(b) Whether management of company while preparing financial statements is compulsorily required to consider International Valuation Standards for the determination of fair values of assets and liabilities under IFRS 13.

**Opinion:**

***Financial reporting framework***

In the context of the submitted fact pattern, the Board noted that a company incorporated under the Companies Act, 2017 (the Companies Act) is required to prepare statutory financial statements in accordance with the requirements of the Companies Act.

Under the Companies Act, the financial reporting framework applicable to companies includes the International Financial Reporting Standards (IFRS) as notified by the Securities and Exchange Commission of Pakistan (SECP).

Further, the Board considered that IFRS Standards are issued by the International Accounting Standards Board (IASB). In Pakistan the IFRS are adopted by the SECP under the Companies Act.

The Board based on the background information and enquiries raised by enquirer considered that the company in the submitted fact pattern is preparing financial statements in accordance with IFRS.

***IFRS 13 Fair Value Measurement***

The Board considered that measurement of assets and liabilities for reporting in the financial statements is a part of overall preparation of financial statements.

Under the IFRS Standards, IFRS 13 Fair Value Measurement provides the framework for measurement of fair value of assets and liabilities. SECP has notified IFRS 13 for adoption under the Companies Act, therefore, it is applicable to a company preparing statutory financial statements under the Companies Act.

Paragraph 5 of IFRS 13 explains that this standard applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements, except for some specified exclusions.

Further, IFRS 13 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.

Paragraph 2 of IFRS 13 explains that this standard outlines a market-based measurement, not an entity specific measurement. It adds that regardless of whether or not observable market transactions and information for an asset or liability is available or not, the objective in both cases is 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 measurement date under current market conditions (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

Paragraph B2 of the Application Guidance in IFRS 13 outlines the fair value measurement approach as follows (underline added and relevant portion reproduced only):

> *"A fair value measurement requires an entity to determine all the following:*
> *(a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account).*
> *(b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).*
> *(c) the principal (or most advantageous) market for the asset or liability.*
> *(d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised."*
> (Emphasis is ours)

***Valuation approaches***

The Board understands that the valuation approaches are broad category of the valuation techniques, while a valuation technique refers to a specific technique such as a particular option pricing model.

IFRS 13 recognises three valuation approaches to measure fair value:

a) Market approach
b) Cost approach
c) Income approach

Paragraph 62 of IFRS 13 outlines three valuation approaches, requiring an entity to use valuation techniques consistent with one or more of these approaches.
Relevant portion of paragraph 62 is reproduced below:

> *"Three widely used valuation techniques are the market approach, the cost approach and the income approach. The main aspects of those approaches are summarized in paragraphs B5–B11. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value."* (Emphasis is ours)

The main aspects of these valuation approaches, as explained in paragraphs B5 to B11 of IFRS 13 are explained below:

a) **Market Approach**: The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

b) **Cost Approach:** The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

c) **Income Approach:** A fair value measurement using the income approach will reflect current market expectations about future cash flows or income and expenses.

The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

IFRS 13 paragraph B11 provides a number of examples of valuation techniques that are consistent with the income approach. However, the Board understands that the standard does not limit the valuation techniques that are consistent with the income approach to these examples; an entity may consider other valuation techniques.

The Board noted that present value techniques are included in the income approach. Paragraphs B13-B30 describe the use of present value techniques to measure fair value. The present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (e.g. whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data.

***Valuation techniques***

The Board would like to highlight that IFRS 13 requires an entity to use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value.

Further, the Board understands that the determination of the appropriate technique(s) to be applied requires significant judgement, sufficient knowledge of the asset or liability and an adequate level of expertise regarding the valuation techniques. Relevant paragraph 61 of IFRS 13 is reproduced below:

> *"An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs."*

The Board understands that IFRS 13 does not prioritise the use of one valuation technique over another. Instead, the standard establishes a fair value hierarchy for the inputs used in those valuation techniques, requiring an entity to maximize observable inputs and minimize the use of unobservable inputs.

***Fair value hierarchy***

With the objective to increase consistency and comparability in fair value measurements and related disclosures, the Board noted that IFRS 13 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value as follows:

a) **Level 1 inputs** are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

b) **Level 2 inputs** are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

c) **Level 3 inputs** are unobservable inputs for the asset or liability.

The fair value hierarchy gives the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs.

### *International Valuation Standards*

The Board noted that the International Valuation Standards are issued by the International Valuation Standards Council.

The Board understands that International Valuation Standards pertain to the ‘Valuers’ profession. Adoption of the valuer profession related standards is not under ICAP’s regulatory ambit.

### *IFRS Standards and International Valuation Standards*

The Board understands that valuation experts are involved in various transactions and industries. For example, in the Oil and Gas industry, for which very important disclosures on the value of resources and reserves are not required by the IFRS. However, certain jurisdictions require professional valuation experts to assess these disclosures. Another example of use of valuation standards could be the option valuation models such as Black and Scholes that can be used for purposes of IFRS 2 Share based Payment even though the specific method or model is not mandatorily specified in the IFRS Standards.

In context of fair value measurement, the Board noted that IFRS 13 does not require an entity to adopt a particular valuation method in given circumstances. The selection of most suitable valuation technique is a matter of management’s judgement in the context of specific facts and circumstances of each case. However, any valuation technique selected must be consistent with the three broad valuation approaches out lined in IFRS 13.

The Board noted that IFRS 13 also does not obligate the application of International Valuation Standards for the determination of fair values under IFRS Standards.

## Conclusion

Based on above discussion, the Board concluded that:

(a) The International Valuation Standards are issued by International Valuation Standards Council, and these standards pertain, in general, to the ‘Valuers’ profession. The adoption of professional standards relating to the Valuers is not under ICAP’s regulatory ambit.

(b) IFRS 13 outlines that in measuring the fair value, those valuation techniques and approaches should be adopted that are appropriate and for which sufficient data is available to measure fair value. Accordingly, selection of the most suitable valuation technique is a matter of management’s judgement in the context of specific facts and circumstances of each case.

IFRS 13 prioritizes the inputs used in the application of valuation techniques. Based on this, the use of observable inputs should be maximized and the use of unobservable inputs be minimized but It does not prioritise the use of one valuation technique over another or require the use of only one technique. IFRS 13 does not obligate the application of International Valuation Standard for the determination of fair values.

*(January 27, 2020)*