Tech Q&A

The IFRS Foundation published educational material to assist preparers in applying IFRS/HKFRS 13 *Fair Value Measurement*. Could you provide details of what is in the material?

In developing IFRS/HKFRS 13 *Fair Value Measurement*, the International Accounting Standards Board was made aware that entities in emerging and transitioning economies had concerns about applying the fair value measurement principles in their jurisdictions. However, the IASB noted the concerns raised, such as the lack of market data or other key information necessary to perform fair value measurements, is a global constraint rather than a regional one. Therefore, educational material would benefit all entities in applying IFRSs.

The IFRS Foundation staff, with the assistance of a valuation expert group, published the first chapter of its educational material, *Measuring the fair value of unquoted equity instruments within the scope of IFRS 9* Financial Instruments, in December 2012.

This chapter illustrates, at a high level, the application of valuation techniques for measuring the fair value of individual unquoted equity instruments that constitute a non-controlling interest in a private company (i.e. the investee) within the scope of IFRS/HKFRS 9, in accordance with the principles set out in IFRS/HKFRS 13. This guidance is equally applicable under IAS/HKAS 39 *Financial Instruments: Recognition and Measurement*. It does not aim to provide comprehensive valuation guidance and, as a result, does not describe all the substantial work that a valuation exercise might entail in practice. Since the material has not been approved by the IASB, its content is only for educational purposes and thus non-authoritative.

The chapter also presents a range of commonly used valuation techniques for measuring the fair value of unquoted equity instruments within the market and income approaches, as well as the adjusted net asset method. This chapter, like IFRS/HKFRS 13 itself, does not suggest the use of a specific valuation technique, but instead encourages the use of professional judgment and the consideration of all facts and circumstances surrounding the measurement. The particular characteristics of the unquoted equity instruments of an investee and the information that is reasonably available to the preparer (i.e. the investor) are two of the factors that the investor will need to consider when selecting the most appropriate valuation technique.

For example, the availability of information about comparable entities in the absence of any information about the expected cash flow stream of an investee might lead an investor to select the comparable company valuation multiples technique rather than the discounted cash flow method. Alternatively, if the investee pays dividends, an investor with limited financial information might consider using valuation techniques based on dividend discount models.

IFRS/HKFRS 13 does not contain a hierarchy of valuation techniques, nor does it recommend the use of a specific valuation technique for meeting the objective of a fair value measurement. However, IFRS/HKFRS 13 acknowledges that, given specific circumstances, one valuation technique might be more appropriate than another. Some of the factors that an investor will need to consider when selecting the most appropriate valuation technique(s) include:

- The information reasonably available to an investor;
- The market conditions (i.e. bullish or bearish markets might require an investor to consider different valuation techniques);
- The investment horizon and investment type (for example, the market sentiment when measuring the fair value of a short-term financial investment might be better captured by some valuation techniques than by others);
- The life cycle of an investee (i.e. what may trigger value in different stages of an investee's life cycle might be better captured by some valuation techniques than by others);
- The nature of an investee's business (for example, the volatile or cyclical nature of an investee's business might be better captured by some valuation techniques than by others); and
- The industry in which an investee operates.

Valuation approaches and techniques

Valuation approaches	Valuation techniques
Market approach – uses prices and other relevant information that have been generated by market transactions involving identical or comparable assets	· Transaction price paid for an identical or a similar instrument of an investee · Comparable company valuation multiples
Income approach converts future amounts to a single current (i.e. discounted amount)	· Discounted cash flow method · Dividend discount model · Constant growth dividend discount model · Capitalization model
A combination of approaches might be used	Adjusted net asset method

In this connection, the table above presents a summary of the valuation approaches and valuation techniques explained in the educational material.

In addition, the fair value measurement of those equity instruments must reflect current market conditions. An investor might ensure that the valuation techniques do this by adjusting them at the measurement date. At initial recognition, if the transaction price represented fair value and an investor uses a valuation technique to measure fair value in subsequent periods that uses unobservable inputs, the investor must calibrate the valuation technique so that it equals the transaction price. Paragraph 24 of the chapter illustrates the use of calibration, through which an investor can ensure the valuation technique of reflecting current market conditions is appropriate in order to determine whether an adjustment to the technique is necessary.

Because of the nature of the inputs used in the valuation techniques (for example, unobservable inputs, such as forecasts or budgets when applying the discounted cash flow method, or performance measures when applying comparable company valuation multiples) and their relevance in the resulting fair value measurements, most of the resulting measurements will be categorized within level 3 of the fair value hierarchy. Accordingly, such fair value measurements will require an investor to prepare additional disclosures. Such disclosures provide users of financial statements with information about the significant unobservable inputs used in fair value measurements categorized within level 3 and about the generally higher subjectivity surrounding fair value measurement at this level.

At the end, the educational material provides an overview of the common oversights when applying the valuation techniques and a list of other publications that can also be referred to.

The educational material can be accessed at the IASB website.

Send your questions and comments to *commentletters@hkicpa.org.hk*. The standard setting team will answer these questions in accordance with its policy, posted on the Institute's website.