

# ILLUSTRATIVE EXAMPLES TO ACCOMPANY IFRS 13 *FAIR VALUE MEASUREMENT* UNQUOTED EQUITY INSTRUMENTS WITHIN THE SCOPE OF IFRS 9 *FINANCIAL INSTRUMENTS* INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/06



## Summary

In December 2012, the IFRS Foundation published education material to accompany IFRS 13 *Fair Value Measurement* for measuring the fair value of unquoted equity instruments that are within the scope of IFRS 9 *Financial Instruments*. IFRS 13 is effective for periods beginning on or after 1 January 2013.

IFRS 9 applies to investments in equity instruments where the investor holds a non controlling interest (e.g. 10% of the ordinary shares) which:

- In its consolidated or individual financial statements, is not required to be accounted for as an associate, joint venture, or joint arrangement
- In its separate financial statements, if the investment is not an interest in a subsidiary, associate, joint venture or joint arrangement unless the investor has elected to measure those investments in accordance with IFRS 9.

IFRS 9 requires all investments in equity instruments that are within its scope to be measured at fair value, regardless of whether they are quoted or unquoted. The educational material is intended to assist entities in measuring the fair value of their investments in unquoted equity instruments because the fair value of those instruments is not typically available.

The education material describes, at a high level, the application of various valuation techniques in the context of the requirements of IFRS 13. It illustrates, with examples, how to measure the fair value of an unquoted equity instrument even if only limited financial information is available. The three valuation approaches and techniques described are:

### 1) *Market approach:*

- a) Transaction price paid for an identical or a similar instrument in an investee
- b) Comparable company valuation multiples.

### 2) *Income approach:*

- a) Discounted cash flow method
- b) Dividend discount model
- c) Constant growth dividend discounted model
- d) Capitalisation model.

### 3) *Adjusted net asset method.*

The education material does not prescribe a specific valuation technique, but encourages the use of professional judgment together with consideration of all facts and circumstances surrounding the measurement.

The educational material has been developed and published by the IFRS Foundation, and as such is non-authoritative.

## STATUS

Final

## EFFECTIVE DATE

N/A

## ACCOUNTING IMPACT

May be significant for entities with investments in unquoted equity instruments that are within the scope of IFRS 9.

## Background

The IFRS Foundation has been tasked by the International Accounting Standards Board (IASB) to develop education material to address the application of the principles in IFRS 13 on different topics. The guidance for fair value measurement of unquoted equity instruments forms a chapter of that education material. Chapters addressing fair value measurement of other topics within the context of IFRS 13 will be published as they are finalised.

IFRS 9 requires all investments in equity instruments within its scope to be measured at fair value. This represents a change from IAS 39 *Financial Instruments: Recognition and Measurement*, which contains a very limited exception from fair value measurement. During the development of IFRS 9, respondents to the exposure draft raised concerns about the elimination of the limited exemption in IAS 39 with some of these concerns being based on the cost and difficulty in determining fair value on a recurring basis.

IFRS 9 does note that, in certain limited circumstances, cost may be an appropriate estimate of fair value for unquoted equity instruments. That may be the case if there is not enough recent information available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within the range. However, IFRS 9 is clear that the use of cost as an approximation of fair value applies in very limited circumstances, and includes a range of indicators of circumstances in which this approach would not be appropriate. The IASB also noted in its Basis for Conclusions to IFRS 9, that the use of cost as an approximation of fair value would never apply to equity instruments held by entities such as financial institutions or investment funds.

The educational material has been published to assist entities with measuring fair value for their unquoted equity instruments. It accompanies IFRS 13, which is effective for periods beginning on or after 1 January 2013. The educational material describes, at a high level, the application of various valuation techniques that can be used to measure the fair value of an unquoted equity instrument despite having limited financial information.

The IFRS Foundation's intention in issuing the educational material is to provide support to personnel responsible for measuring the fair value of unquoted equity instruments that are within the scope of IFRS 9. It is not intended to be a comprehensive document to support non-valuation specialists in performing complex valuations.

## Approaches to valuation

The educational material describes three different valuation approaches, and the different valuation techniques under those approaches that are in accordance with the principles in IFRS 13 and could be applied in determining the fair value of an unquoted equity instrument. However, regardless of the valuation technique used, the fair value measurement of those equity instruments must reflect market conditions at the investor's reporting date.

### 1) Market approach

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets. The following valuation techniques are described under the market approach in the document:

- a) Transaction price paid for an identical or a similar instrument in an investee
- b) Comparable company valuation multiples.

### a) Transaction price paid for an identical or a similar instrument in an investee

If an investor has recently acquired an investment in another equity instrument that is identical or similar to the unquoted equity instrument being valued, then the price for that transaction might be a reasonable starting point for measuring fair value.

#### (i) Identical instrument

If the equity instrument that was recently acquired is *identical* to the unquoted equity instrument being valued, the investor should assess whether factors or events that have occurred after the purchase date that could affect the fair value of the unquoted equity instrument at measurement date. If so, the investor should adjust the transaction price for those factors. Factors could include changes in market conditions that have affected the investee's growth prospects or expected milestones, or internal matters such as fraud, commercial disputes, changes in management or strategy.

#### (ii) Similar instrument

If the equity instrument that was recently acquired is *similar* to the unquoted equity instrument being valued, the investor needs to understand, and make adjustments for, any differences between the two equity instruments. Differences might include different economic rights (e.g. dividend rights, priority upon liquidation etc) and control rights (i.e. control premium in a controlling interest vs. a non-controlling interest).

### b) Comparable company valuation multiples

This technique assumes that the value of an unquoted asset can be measured by comparing that asset to similar assets where market prices are available. Information can usually be sourced from quoted prices and/or observable data from transaction such as mergers and acquisitions. This technique involves the following four steps:

#### (i) Step one: Identify comparable company peers.

#### (ii) Step two:

- Select the performance measure that is most relevant to assessing the value of the investee (earnings, equity book value or revenue)
- Once selected, derive and analyse possible valuation multiples and select the most appropriate one (e.g. EBIT, EBITA, EBITDA, or P/E for earnings, P/B for book value)
- Adjust the relevant multiple as appropriate for general qualitative differences between the investee and its company peers (e.g. size in terms of revenues or assets, level and rate of growth of earnings, diversity of product range, diversity and quality of customer base, leverage location, lack of liquidity).

#### (iii) Step three: Apply the appropriate valuation multiple to the relevant performance measure of the investee to obtain an indicated fair value of the investee's equity or the enterprise value.

Note: for the purposes of the educational material, enterprise value is the fair value of all financial claims attributable to all capital providers (i.e. debt and equity holders).

#### (iv) Step four: Make appropriate adjustments for differences that are directly related to the characteristics of equity instruments being valued (e.g. non-controlling interest discount, lack of liquidity).

## 2) *Income approach*

The valuation techniques under the income approach convert future amounts to a single current (i.e. discounted) amount. The following valuation techniques are described in the document:

- a) Discounted cash flow method
- b) Dividend discount model
- c) Constant growth dividend discounted model
- d) Capitalisation model.

### a) *Discounted cash flow method*

Under this method, the investor would discount the expected cash flows amounts to a present value at a rate of return that represents the time value of money and the relative risks of the investment. Equity instruments can be valued directly using 'free cash flow to equity' (i.e. an equity valuation), or indirectly, by obtaining the enterprise value using 'free cash flow to firm' and then subtracting the fair value of the investee's debt net of cash.

### b) *Dividend discount model*

This model assumes that the price of the equity instrument equals the present value of all its expected future dividends in perpetuity. It is often used when the investee pays dividends consistently.

### c) *Constant-growth dividend discount model*

This model determines the fair value of the equity instrument by referring to a forecast of growing dividend streams. This model is sensitive to the assumptions about the growth rate. The model is best suited for investments that both:

- Are growing at a rate that is equal to or lower than the nominal growth rate in the economy
- Have a well established dividend payout policy that the investee intends to continue into the future.

### d) *Capitalisation model*

This model applies a rate to an amount that represents a measure of economic income (e.g. free cash flows to firm or free cash flows to equity) to arrive at an estimate of present value. The model is useful as a cross-check when other approaches have been used.

## 3) *Adjusted net asset method*

The adjusted net asset method is a combination of the market and income approach. It involves directly measuring the fair value of the recognised and unrecognised assets and liabilities of the investee. This method is likely to be appropriate for entities that derive value from holding assets (such as property holding companies or investment entities) and may also be appropriate for entities in their early stages that have little financial history and may not yet have developed products.

Typically, the adjusted net asset method involves making adjustments to the balance sheet carrying amounts of assets and liabilities. Items that are commonly subject to adjustments include:

- Intangible assets
- Property plant and equipment
- Receivables
- Inter-company balances
- Financial assets not measured at fair value
- Unrecognised contingent liabilities.

Once an equity valuation has been derived, the investor would also need to consider making the following adjustments for its share of the investee's equity instruments held:

- Non controlling interest
- Lack of liquidity
- The passage of time that could have an effect on the changes in fair value of the assets and liabilities or any additions/disposals
- Any other contractual agreements specific to the equity instruments held etc.

### Use of judgement

When determining a price that is most representative of the fair value, an investor needs to consider:

- Which valuation technique makes the least adjustment to the inputs used (and, consequently, which technique maximises the use of relevant observable inputs, which is the valuation approach that IFRS requires)
- The range of values indicated by the techniques used and whether they overlap
- The reasons for the differences in value under different techniques.

Depending on the circumstances, one valuation technique might be more appropriate than another. Some of the factors that need to be considered when selecting the most appropriate valuation technique include:

- Information that is 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 the type of investment
- The life cycle of the investee (some valuation techniques are better at capturing the market sentiment when measuring the fair value of a short-term financial investment)
- The nature of an investee's business (some valuation techniques are better at capturing the volatile or cyclical nature of an investee's business)
- The industry in which the investee operates.

Judgement needs to be applied both in the application of a particular valuation technique and in the selection of the valuation technique. For example, an investor is likely to place more emphasis on the comparable company valuation multiples techniques, where there is a sufficient number of comparable peers.

### Common oversights

The educational guidance also sets out a list of common oversights when applying the valuation techniques it describes, or determining their inputs. While not exhaustive, these may assist entities in avoiding potentially significant errors.



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