ACCOUNTING MEETS VALUATION

SUMMARY REPORT

BRUSSELS, 5 DECEMBER 2017

European Financial Reporting Advisory Group

This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by neither the EFRAG Board nor the EFRAG Technical Expert Group. It has been reviewed by the speakers at the event.

Introduction

EFRAG organised a conference with the title 'Accounting meets valuation' in Brussels on 5 December 2017. This report has been prepared for the convenience of European constituents to summarise the event. All of the speakers' biographies can be found in the EFRAG website, here.

Participants and panellists were welcomed by the EFRAG Board President Jean-Paul Gauzès.

Sir David Tweedie, Chairman of the International Valuation Standards Council (IVSC) Board of Trustees, gave a keynote speech on how valuation experts and accountants work together.

Peter Sampers (Chairman DASB and EFRAG Board member) facilitated a panel discussion on "Merits and limitations of fair value in financial reporting" after an introductory presentation by Mauro Bini (Member of the IVSC Standards Review Board, Chairman of the Management Board of Organismo Italiano di Valutazione, Member of the IAASB Consultative Advisory Group and Full Professor of Corporate Finance at Bocconi University). Panellists included:

- Jannis Bischof (Professor of Accounting University of Mannheim and member of the EFRAG Financial Instruments Working Group);
- Alain Deckers (Head of unit, Accounting and Financial Reporting, DG FISMA – EC);
- Vincent Papa (Director Financial Reporting Policy for Capital Markets, CFA Institute and member EFRAG User Panel); and
- Ann Tarca (Member of the International Accounting Standards Board (IASB)).

Andrew Watchman (EFRAG TEG Chairman and CEO) facilitated a second discussion on "Challenges in using fair value" after a presentation by Henk Oosterhout (Managing Director, Duff & Phelps). Panellists included:

- Stephen Cooper (Analyst and former IASB member);
- Tanguy Dehapiot (Head of Valuation Risk, BNP Paribas);
- Roxana Damianov (Team Leader Corporate Finance and Reporting Investors and Issuers Department, ESMA); and
- Daniele Solaroli (Director Corporate Finance, PwC).

The event was summarised and closed by the EFRAG Research Director Filippo Poli.

Welcome

Jean-Paul Gauzès welcomed everyone to the conference which brings together financial reporting and valuation experts. He commented that both valuation experts and accountants will bring their different perspectives to discuss why and when fair value enhances financial reporting.

He reminded the audience that EFRAG's mission is to serve the European public interest by developing and promoting European views in the field of financial reporting. He emphasised the different work streams of EFRAG.

Jean-Paul then briefly presented the two round-table discussions on the theoretical and practical aspects of fair value. He then introduced and welcomed to the stage the key note speaker - Sir David Tweedie, previously Founding Chairman of the IASB and CEO of the IFRS Foundation, currently, Chairman of the IVSC Board of Trustees.

Key note speech – Valuation experts and accountants working together

Sir David Tweedie discussed the role of the IVSC in bringing financial reporting and valuation practices together. The presentation is available in the EFRAG website, here.

He indicated that the prerequisites of successful global standards are the acceptance of the need for such standards and a strong, respected, identifiable profession to implement and enforce the standards. He then discussed the need for global standards using IFRS as an example. He commented that valuation was at the core of both financial reporting under IFRS and US GAAP as well as financial stability. He reminded the audience that the G20 and the Financial Stability Forum concluded that differing and inconsistent valuation practices between financial institutions and across national borders had been a part of the problem in the 2008 crisis. This undermined global confidence, raising uncertainty about counterparties' risks position, and leading to contagion within markets, classes and regions. Reliable and consistent valuation is also of fundamental importance to prudential regulators and market participants in determining the capital adequacy of financial institutions. Finally, valuation is also an integral part of the risk management processes applied by financial institutions and other businesses.

Sir David briefly discussed the history of the IVSC and discussed its current objectives which are:

- the development of high quality international valuation standards which underpin consistency, transparency and confidence in valuations globally;
- to be seen and referred to as the standard setter for valuation with international valuation standards (IVS) which are recognised and over time adopted by key stakeholders around the world; and
- to add status to IVSC member and sponsor organisations and the valuation profession.

He then discussed some of the challenges facing the valuation profession, which includes the past fragmentation of valuation approaches by asset category. Often valuation is regarded as a technique rather than a profession as it is unclear what the accepted qualifications are which in turn leads to a lack of recognition by regulators, other professions and prospective recruits. He also briefly covered the attributes of a profession such as exclusivity, standards based on a conceptual underpinning, entry and qualification requirements, continuing professional developments, a code of ethics as well as monitoring and oversight.

Given the use of fair value in IFRS, there is a common interest to ensure that IVS is consistent with IFRS. This led to a protocol between IVSC and the IASB, to provide inputs to each other's standards, share staff and information as well as organise joint discussions on pertinent issues. He underlined the benefits of an effective IVSC which include increased confidence and stability across financial markets, facilitating business across the world, valuation professionals' works being relevant globally and becoming seen as a high calibre profession.

He indicated that, among other issues, intangibles were still an area where a lack of valuation standards led to companies having a lot of off-balance-sheet assets. Other areas like mining assets, pensions, agriculture, or financial instruments give rise to cost versus fair valuation disputes. He stressed that poor valuation affects balance sheets, income statements, and finally the capital buffers and ultimately, financial stability.

Sir David discussed some of the valuation issues around financial instruments that can result in observed differences of up to 140% on hypothetical portfolios. Another issue is differences in valuation for financial reporting versus regulatory reporting and the reasons thereof. The conflicting approach between accounting standards and the current view of market participants on topics such as the funding adjustment and concentration risk also cause debate. The IVSC has responded to these issues by arranging a Task Force meeting in 2016 involving various key players such as regulators, financial institutions, auditors, credit rating agencies etc. The focus was on valuation of financial reporting and market activities; increased transparency around valuations to avoid regulators deliberately increasing capital requirements as a result of doubts about valuations. The aim was also to enhance governance and internal controls.

Sir David acknowledged that IFRS 9 Financial Instruments is a simplification of accounting for financial instruments compared to IAS 39. Whereas IAS 39 is rule based and complex with multiple impairment models, IFRS 9 measurement is based on the business model and the contractual cash flow characteristics of a financial asset. He then provided an overview of expected loss under IFRS 9 compared to the incurred loss model under IAS 39 and a comparison to US GAAP.

Concluding, his vision for the future of the valuation profession is one of partnership between the IVSC, valuation and accounting professional institutes across the globe; with IVS required by IFRS and regulators and implemented by internationally accredited valuation experts.

Round-table on Fair value - the theory: Merits and limitations of fair value in financial reporting

Peter Sampers welcomed and introduced the panel members. The purpose of the panel is to discuss the merits and limitations of fair value in financial reporting and the topic was introduced by a presentation by Mauro Bini.

1. Fair value and the predictive ability of income

Professor Bini explained that net income is the difference between the net assets at the end of the period compared to the beginning of the period. However, where more estimates are incorporated into the measurement of assets and liabilities, the less predictable the resulting income. Stable income in a volatile world is not of much interest and predictability of income itself is not an objective of financial reporting. Rather, the ability of income to predict future cash flows is what matters.

2. Fair value and accruals

He then discussed the relationship between fair value and accruals with the latter being the starting point of analysts to develop forecasts. However, fair value accrual (i.e. unrealised gains and losses) is not always such a starting point. Incorporating fair value accounting information into an historical-cost-based accounting system is challenging and requires thought to the specific presentation of performance. Whilst fair value is an “exit price”, some assets will never be disposed of. Moreover, some fair value estimates assume hypothetical market participants in hypothetical markets.

3. Relevance vs reliability

Fair value measurement is economically relevant even when markets become less liquid with level 1 and 2 measurements regarded as more relevant than level 3. Gains and losses from level 3 fair value measurements are not always considered relevant as the market may not consider them to be reliable.
He gave the example of two property investment firms with portfolios of different quality. The market will assume both to be of the same quality unless provided with information to the contrary. To validate its fair value, the firm with the higher quality portfolio would need to provide a credible signal to the market, such as hiring professional valuation experts or realising a part of the portfolio.
Potential management bias can be countered by disclosure about methodology and main assumptions. There is also the inherent risk of measurement error in assets. Regulators and auditors have a role to play in limiting the available latitude in estimating fair value.

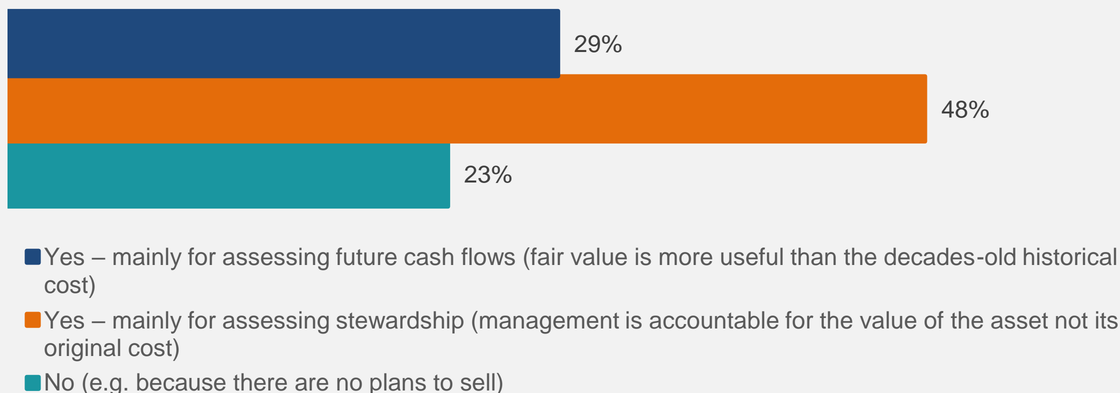
4. Reliability costs

Most managers choose historical cost as the measurement basis for non-financial assets when given the option, but this is counter-intuitive when considering that net economic benefits of fair value accounting exceed that of historical cost. Professor Bini argued that this presumably means that the costs of confirming reliability in the form of a credible signal are too high and confirms Sir David's comments about the need for a credible profession in the field of valuation.

Professor Bini's presentation is available in the EFRAG website, here.

Roundtable discussion

Audience poll question 1: A company's office building is located on a plot of land that was acquired decades ago. The land could be sold, but the company has no plans to sell. Do you think the fair value of the land is relevant information for users of financial statements?



- Yes – mainly for assessing future cash flows (fair value is more useful than the decades-old historical cost)
- Yes – mainly for assessing stewardship (management is accountable for the value of the asset not its original cost)
- No (e.g. because there are no plans to sell)

How do you see the role of fair value in bringing better transparency and more comparability? In what circumstances is fair value more (or less) relevant?

Ann Tarca stated that transparency and comparability are accepted as important attributes of financial information and that standard setters use fair value measurement to increase transparency and comparability. Users commented that the disclosures around fair value measurement are useful during the Post Implementation Review on IFRS 13 Fair Value Measurement. This refers to the fair value hierarchy and sensitivity information as well as the inputs to the valuation models. These beneficial disclosures provide transparency and comparability that was missing previously.

Vincent Papa concurred that fair value measurement has increased transparency. He questioned whether fair value measurement intrinsically creates opportunities or incentives to increase profit compared to other measurement bases, but may be difficult to ascertain.
Member surveys conducted by the CFA Institute reflected strong support for publicly traded instruments to be measured at fair value as well as majority support for loans, deposits and financial liabilities at fair value even during the crisis. Historic cost was favoured for both non-financial assets or liabilities. He referred to the popularity of non-GAAP measures and that these usually exclude fair value remeasurements to achieve "persistent" or "sustainable" earnings. However, valuation relevance also considers the predictive value and relevant risks as well as

a combination of those. He mentioned the measurement uncertainty associated with reported fair values also necessitates the need for robust accompanying disclosures.

What have we learned about fair value since the global financial crisis?

Jannis Bischof remarked that hindsight and academic evidence refutes the view expressed during the crisis that fair value measurement contributed to or exacerbated the crisis. When considering the balance sheet structure of banks, fair value measurement did not play any meaningful role in the failing of banks during the crisis in the US as well as in Europe. The theoretical argument that fair value measurement impacted the financial system indirectly through fair value write-downs or distress sales of assets by banks has been refuted since the crisis.
Where distress sales of assets result from the use of fair value in private contracts such as margin calls and collateral requirements, this is outside the scope of accounting standards. He is of the view that while accounting may have added to the problems during the crisis, this related less to fair value measurement and more to a lack of timely impairment or standardised disclosures.

Ann Tarca commented that while, early-on during the financial crisis fair value was often blamed, academics have done considerable research that contradict this as mentioned by Professor Bischof. Standard setters have also responded to criticisms with considerable work on standard setting for financial instruments post the crisis which culminated in the issue of IFRS 9 Financial Instruments. The IASB works closely with the Basel Committee on Banking Supervision, ESMA and IOSCO to address all the related issues as not all the problems fall under the provenance of one regulator or supervisory body. Immediately post crisis the IASB and the IFRS Foundation also created an expert committee to discuss fair value measurement in illiquid circumstances and the outputs filtered through to IFRS 13.

> ***“The estimation of fair value is a combination of art and science, but it also could be characterised as craftsmanship.”***

If there are no observable inputs, how can we measure fair value?

Mauro Bini indicated that the fair value of an asset is an estimate and not a precise number, but such an estimate can be structured according to standards. Valuation, accounting and auditing need to work together to get an appropriate result. Furthermore, faithful representation does not mean a sure outcome, it refers to a neutral rather than a biased result.

Vincent Papa commented that faithful representation also has its challenges when considering the historical cost basis where pre-crisis there were “gains trading” as an example of opportunistic behaviour at play. The advantage of fair value measurement is that the preparer has less control over the timing of recognition however there may be more upward bias of the measurement basis. However, with historical cost a preparer can influence the timing of recognition of gains and losses.

Is it useful to consider markets to be efficient when setting standards – or should the starting point be that markets are imperfect?

Jannis Bischof thought the starting point for setting standards should be the reality that markets are imperfect. If this was not the case, there would be much less need for accounting standards.

Ann Tarca pointed out that the role of the standards is to help preparers in these imperfect markets.

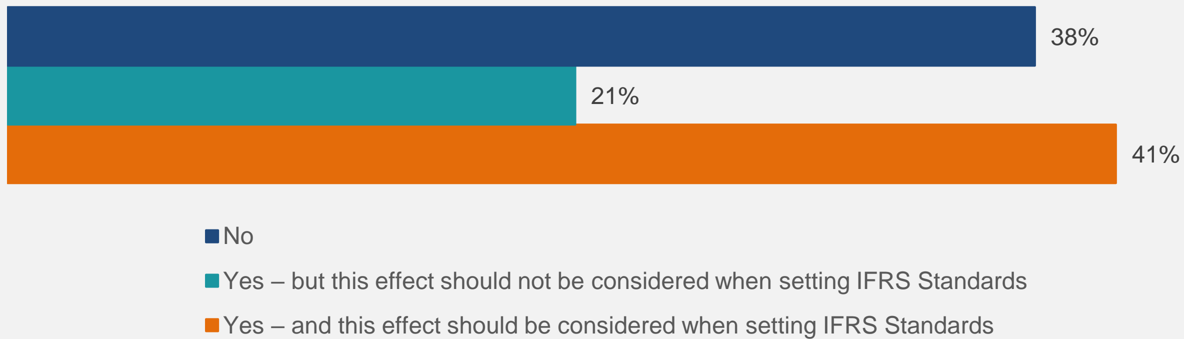
Is there a role for sustainability in valuation standards?

Alain Deckers indicated that from a public policy perspective, one would want management to internalise externalities, as there would be inefficient outcomes if private actors do not pay the full price that reflects the true social costs. This is unlikely to be an issue for accounting standards as accounting reflects the transaction price which would not include these externalities. However, valuation standards could provide models to estimate the impact of externalities on price and this could help to internalise these external costs. He then considered the debate on stranded assets where you have long-lived assets that are impaired e.g. due to climate change and whether this is reflected and how IAS 36 on Impairment of assets is implemented in practice. Therefore, sustainability issues could be relevant, but judgement is required as to the usefulness of any outcome. For example, a net present valuation based on discounted cash flows of a very long-lived asset would be more sensitive to changes in the discount rate than to the undiscounted cash flows.

Mauro Bini commented that sustainability drives firm value as the three drivers of value are growth, risk and profitability. Sustainability increases growth due to an improvement in reputation and ability of the entity to attract intellectual capital and financial capital. Sustainability reduces risk, specifically diversifiable risk, and increases profitability by reducing waste for example. There is also an indirect linkage to value as companies with stronger corporate governance have more sustainable business models and the literature indicates that good corporate governance is linked to the reliability of fair value measurement. For example, the discounts implied by the market on level 3 instruments are lower for companies with strong corporate governance. Therefore, sustainability and corporate governance can mitigate information asymmetry in fair value estimates of level 3 items.

Vincent Papa added that there is a growing impetus for more information about long-term value creation possibilities and remarked on the work done by the IIRC in this regard on disclosure. However, the interplay between fair value measurement and incentives for long-term investment strategy requires more and robust research.

Audience poll question 2: Do you think measurement at fair value encourages 'short-termism'?



Can fair value in financial reporting have unintended consequences? Is there a role for financial stability in valuation standards?

Alain Deckers mentioned that uncertainty in estimates could lead to uncertainty in the market and this could have a destabilising impact on financial stability if not managed properly. The link between fair value as a measurement basis and the underlying business model as recognised in IFRS 9 is important. He questioned whether the concern of procyclicality has been fully laid to rest despite what has been said about recent academic research and what the behavioural impacts are where the fair value estimate does not reflect what the market is doing e.g. fair values realised due to distress sales in illiquid markets.

Ann Tarca pointed out that while regulators aim to protect creditors, the accounting standards focus on equity investors and that different objectives result in different responses.

Jannis Bischof stated that regulators can make the required prudential adjustments when relevant and discussed the criticism that fair value measurement can lead to short-termism. He acknowledged that fair value measurement may result in short term gains, but that the earlier loss recognition has a positive disciplining impact on management. A study compared banks in regulatory settings where fair value losses directly impact regulatory capital or not and in the former, such losses can signal to management to raise new capital, reduce dividends or risk-weighted assets.

Would the use of fair value measurement have an impact on short-term thinking?

Ann Tarca indicated that during standard-setting several views would be represented around the table and this would include short, medium and long-term considerations. Standard-setters do not create standards that will prevent opportunism, but unintended consequences are considered during the process in the discussions and field-testing. **Alain Deckers** raised the question of whether accounting standards objectively measures financial performance and position like a neutral science would or whether it is rather contextual in nature. He stated that as there is no such thing as the fair value, it is only defined with reference to a specific framework such as IFRS. He considered that the

conclusions in accounting standards could be driven by social or political considerations and if this is accepted, it would be legitimate to ask questions about the broader public policy considerations.

How does estimation uncertainty affect usefulness of information?

Vincent Papa recalled situations where the measurement uncertainty of assets was much higher than materiality level and asked whether such information was auditable. Both accounting standard setters and auditing standard setters have a role to ensure the necessary tools and audit techniques.

Jannis Bischof pointed out that the estimation uncertainty reflects the uncertainty in the economic underlying and did not think that cost information alone would be helpful to predict future income or performance in these cases. He stated estimation uncertainty provides management with discretion that can be abused in the absence of the appropriate risk management and appropriate enforcement.

"Well-managed companies that are well-governed and pay attention to sustainability might be expected to create more value as they are managing resources appropriately and optimally."

How does (or how should) the IASB work together with valuation experts?

Ann Tarca answered that there is co-operation already but that there will be more interaction in the future. She provided the example of the Oil and Gas industry, for which very important disclosures on the value of resources and reserves are not required by the accounting standards. However, certain territories require professional valuation experts to assess these disclosures. She also referred to option valuation models such as Black and Scholes that can be used for purposes of IFRS02 *Share-based Payment* even if the specific method or model is not specified in IFRS.

Mauro Bini considered the distinction clear: the accountants decide what should be fair valued and the valuation experts determine the appropriate way to do so - all this under the watchful eye of the auditors. He echoed Sir David's comments about valuation as a profession and said that this requires standards dealing with professional, performance and specific topics along with global enforcement activities. For example, in 2012 the OIV (the Italian valuation standard-setter) issued a document on impairment that required listed companies to comply or explain. Subsequently impairment losses of EUR 20 billion were recognised where no losses were recognised during the crisis.

Closing remarks

Alain Deckers said in the context of intangibles, the uncertainty around valuation creates a barrier to recognition of internally created intangible assets and that raises a question about level 3 items, but that fair value should not be considered to be inherently good or bad. Abuse of fair value can be bad but, as many pointed out, cost accounting can also lead to negative consequences.

Ann Tarca requested continued feedback to the IASB on post-implementation reviews, discussion papers and exposure drafts as the IASB modifies its position based on what can be accommodated. She said that accounting standards are a social construct and so may not be perfect, but the IASB will be responsive whilst considering the cost-benefit trade-off.

Jannis Bischof concluded that the question whether fair value overall is beneficial or not depends on the quality of the accompanying disclosures and the quality of the enforcement system and will continue to generate debate.

Mauro Bini pointed out the academic literature that says fair value is economically relevant and that more disclosures and best practice may help preparers in this regard.

Vincent Papa referred to valuation being an art and a science that needs to be improved to assist in comparability and consistency. This could also help to provide more information about a broader range of assets (including intangibles) for the benefit of users.

Peter Sampers thanked panellists for their input and closed the session.

> **“Stable earnings or the absence of volatility in the P&L will not necessarily lead to financial stability.”**

Round-table on Fair value - the practice: Challenges in using fair value

The purpose of the panel was to discuss the practical challenges in using fair value. Andrew Watchman welcomed and introduced the panellists. The topic was introduced by Henk Oosterhout.

1. Fair value: history within IFRS

Henk Oosterhout discussed the history of fair value within IFRS such as at the mandatory adoption of IFRS in the EU in 2005, which had a particular impact on the accounting for business combinations and share-based payments. This was followed by the FASB issuing SFAS 157 which dealt with Fair Value Measurements and Disclosures in 2008. IFRS 13 Fair Value Measurement and IFRS 9 Financial Instruments are effective for years beginning on or after 1 January 2013 and 2018 respectively. The use of fair value in IAS 36 Impairment of Assets requires special attention in the fair value debate.

2. Fair value: relevance versus reliability

The increased comparability resulting from the use of fair value measurement evidences the relevance of fair valuation. However, he emphasised that market prices were objective, but values are not which has implications for reliability. This means that users need further information on valuation methods and inputs. He also emphasised that preparers should be encouraged to improve consistency and disclosures.

He presented graphs of the market capitalisation of S&P Europe 350 index as well as headroom between market capitalisation and the book value of equity. The S&P Europe 350 index showed a market capitalisation of EUR 9.3 trillion, with the largest average market capitalisation in healthcare, energy and consumer staples sectors. He pointed out a large headroom in industrials, technology and media and consumer staples business sectors for a total of EUR 4.4 billion and he remarked that this difference requires explanation to investors. He also observed that market values of financial institutions are below their equity book values which raises questions about hidden impairment losses.

3. Valuation methods used in practice

Henk Oosterhout recalled the main valuation approaches used in practice- quoted price approach for level 1 fair values, market approach for level 2, and income approach for level 3 items. He also considered the increase in the proportion of fair value assets to total assets of listed firms which requires better disclosures such as presentation of market to book values and return on invested capital ratios. Furthermore, he emphasised the need for consistency of valuation methodology and input selection over time, comparability as well as the level 3 reconciliation (i.e. fair value bridge) and the need for more voluntary disclosure.

He then presented graphs to reflect a high positive correlation between the relative size of goodwill and intangible assets and the market-to-book ratio. There is a strong negative correlation debt-to-capital ratio as a percentage of market to book value ratio which is informative for investors.

4. Fair value and market prices

He concluded that while fair value may increase volatility the question is whether this is a cause or a consequence. He emphasised the importance of management discussion and analysis that focus on value drivers and provide forward looking information.

Henk Oosterhout's presentation is available in the EFRAG website, here.

Roundtable discussion

Audience poll question 3: Do you think that IFRS 13 Fair Value Measurement has improved consistency in fair value estimation in IFRS?

What have we learned about fair value since the global financial crisis?

Tanguy Dehapiot commented that valuation is not an exact science and should be considered to consist of both mathematics and art. Valuation uncertainty exists and it needs to be assessed as well as measured: prudential regulators developed the prudent valuation framework for this purpose.

Finally, he recalled the importance of the internal control function's role to independently verify valuation processes and that governance, in turn, needs to be challenged by auditors and regulators.

Roxana Damianov made a distinction between prudential and securities regulators and commented that accounting and prudential regulators have reacted differently to the challenged posed due to the financial crisis as they pursue different objectives. From a securities' regulator standpoint, she pointed to the fact that the crisis has increased awareness of the dangers of a widening gap between market valuations and economics of the underlying transactions and that accounting standards should be a link between these two. All actors in the market, such as auditors, preparers, regulators, and individuals have their role to play to impose discipline on the use of fair value.

Henk Oosterhout agreed that fair value measurement is a combination of art and science but also could be characterised as craftsmanship: it takes experience to improve.

Stephen Cooper considered the most important lesson learned to be the importance of transparency. This bred confidence which was good for stability of financial markets. Consequently, disclosures are key, which would include measurement uncertainty but also disclosures of fair values of the assets not measured at fair value. Particularly, he pointed to the lack of such disclosure requirements for loan books, prior to the crisis time.

Daniele Solaroli indicated that preparers regard volatility as an issue. He provided a few examples based on his experience.

> **"Wealth is determined with respect to current market values of net productive assets at the beginning and the end of the period. This only holds when wealth can be measured reliably."** John Hicks, *Value and Capital,* 1939
>
> As quoted

What are the main advantages (under which circumstances) and main disadvantages (under which circumstances) of measuring at fair value?

Tanguy Dehapiot considered fair value not to be appropriate in asset and liability management, in particular when measuring demand deposits invested in loans. The economic inflow is a net margin and the fair value of the loan without a corresponding impact on the demand deposit would be meaningless. He emphasised that, generally, care should be taken when fair valuing assets that are not intended to be sold.

Stephen Cooper considered fair value measurement appropriate for property and investment portfolios and many expenses e.g. share-based payments. Furthermore, measurement uncertainty should not be a barrier for the use of fair value, but disclosures would be expected. However, there may be disadvantages for the use of fair value for business models where valuation reflects and focuses on cash-flows rather than fair value of underlying assets.

Roxana Damianov considered that a mixed model, on which fair value was required for some assets but not for others, and where different levels of fair value can be used depending on the factual circumstances, better reflects the complexity of the underlying economic reality. She noted that this comes at a cost as level 3 fair values were considered by users of financial statements to have a different level of reliability.

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What do financial statements need to explain about fair values?

Roxana Damianov considered that it was almost impossible to depict in financial statements the complexity of companies' businesses, nevertheless it was the best tool available. The most important factor would be that entities consider the objective of disclosures required in IFRS 13 and put the fair value in the right context. She recalled that ESMA's recent study indicated a good level of compliance with IFRS 13 but recommended improvements on disclosures of level 3 instruments particularly during periods of stress. On the latter point, she highlighted the importance of sensitivity analyses and any valuation adjustments. In general, she recalled the relevance of the connection between fair value measurement and the overall business of the entity.

Stephen Cooper added that it is important to provide disclosure about inputs to the measurements and valuation models and processes. This would give more confidence on presented fair values to investors.

Tanguy Dehapiot challenged the need to present detailed information to investors, nevertheless, he thought that it was important to present such information to regulators.

Daniele Solaroli considered that fair value disclosures were important not only for users of financial statements but may also serve as benchmarks for valuation experts, e.g. inputs relating to the valuation of a brand.

Can fair value in financial reporting have unintended consequences? The use of fair value can result in showing volatility: does it matter?

Stephen Cooper emphasised that companies should not fear fair values and resulting volatility. He used a long-term investment in a property portfolio and stated that in his opinion fair value is the only relevant measurement basis for a property portfolio. Regular fair value information of a good quality is essential to support long-term investment. He also pointed out that investors consider components of profit and loss and not just the bottom line. However, he thought volatility resulting from accounting mismatches could create interpretation difficulties.

Tanguy Dehapiot, however, challenged the usefulness of presenting counterparty credit risk in interest rate swaps and the volatility resulting from own credit risk.

Roxana Damianov agreed with Tanguy Dehapiot that using fair values in some cases could be debatable, however, she would not in general consider that fair value increases volatility.

Should financial statements explain the stock market valuation?

Henk Oosterhout clarified that a significant difference between the market and book value deserves further explanation, but without necessarily quantifying the components of the difference. **Stephen Cooper** challenged the use of fair value for intangible assets and did not believe it was a good way forward. **Daniele Solaroli** thought that entities should explain differences between the book and market values as the financial statements only present the past transactions and not the value of internal developments (e.g. internally generated intangible assets).

Consistent approach to capital valuation adjustment (KVA) in derivative valuation

Tanguy Dehapiot considered that we are not ready yet for KVA as the concept of the funding valuation adjustment needed to be accepted first.

Can professional valuation experts add to companies' view on level 3 fair values

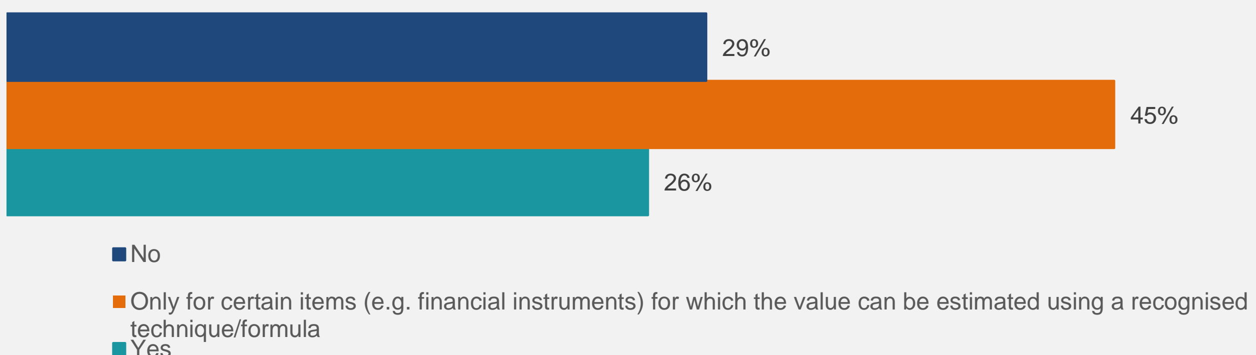
Henk Oosterhout considered that valuation experts may challenge companies to elaborate regarding forecasts, market inputs, comparison with competitors, and consistency of application. An example would be how a current long-term business plan compared to previous long-term plans. **Tanguy Dehapiot** thought that professional valuation experts provide a useful external independent opinion.

> **"Faithful representation does not mean a sure outcome; it refers to a neutral rather than a biased result."**

What are the practical challenges in estimating fair value on an IFRS 13 basis?

Daniele Solaroli considered three main valuation techniques that could be applied in fair value measures for financial reporting – income approach, market approach, and cost approach. He explained that assessments for the income approach for each component of the valuation, i.e. cash flows, terminal value, and discount rate, are subjective and judgmental. Moreover, the valuation standards provided limited application guidance. The market approach also requires adjustments – for example p x q is usually adjusted for a minority discount or a control premium. If there are no market prices, valuation experts could use multiples, but the challenge was to choose an appropriate pool of comparable companies or transactions. The cost approach required assessment of costs to be incurred to build a perfect copy of the asset in the current state and condition. The challenges therefore included adjustments of the replacement cost for obsolescence.

Audience poll question 4: Do you think that it is generally possible to faithfully represent fair value information in the absence of active markets?



Value in use and fair value – are they so different?

On the differences between value in use and fair value, **Henk Oosterhout** explained that the value in use considered management's view on use of the asset compared to fair value which considers that of a market participant. Where the value in use is higher than fair value less costs to sell this could reflect that the business or asset created value for the company and hence a reason not to sell. **Stephen Cooper**, considered the two to be converged even if they arise from different perspectives. The differences related to restrictions with respect to value in use such as including restructuring and capital expenditures.

Shall we believe the accounting or prudential framework for fair value?

Tanguy Dehapiot explained that prudential valuation should be considered a value under stress scenario, but it should measure the same thing as fair value, i.e. it is a going concern value. He recalled that prudential valuation was introduced by banking regulators given that different financial institutions estimate very different values for the same instrument. He expected IVSC to work on reconciliation of prudential value to fair value. **Roxana Damianov** reacted and explained that there were different measures for different regulators: securities regulators would focus more on transparency, whereas prudential regulators require a certain measurement for the purpose of financial stability. Moreover, from the users' perspective, only a part of the prudential values was public.

> **"The consensus amongst academics is that fair value measurement did not contribute to or exacerbate the crisis in any meaningful way."**

Closing remarks

Henk Oosterhout considered fair value important not only because of its relevance, but also because it says something about the intrinsic abilities of the company. He encouraged companies to discuss this more broadly and to avoid boilerplate disclosures.

Stephen Cooper asked the audience not to fear fair value and volatility and said that stable earnings would not necessarily lead to financial stability. He considered fair value to be the most relevant measure in many circumstances. He recalled one of the audience' questions and replied that the fair value of interests in associates whose shares are quoted should be measured on a "p x q" basis without adjustments.

Daniele Solaroli concluded that fair value (and in particular level 2 and level 3) should be considered a standardised value, based on IFRS principles (relevance) and the best estimation practices whilst keeping comparability and consistency in mind (reliability). He considered it important to base valuation on sound and auditable inputs (reliability, again).

Roxana Damianov considered that the informative power of fair value is maximised by having good disclosures and therefore no trade-off is required between transparency and reliability as they go hand in hand.

Tanguy Dehapiot indicated that he disagreed with Stephen Cooper on p x q. He also cautioned that imposing legal-type rules on estimating fair value without a sound economic underpinning could lead to abuse as traders could easily take advantage of an uneconomic, yet legal fair value with transactions that shows a profit without economic justification.

Andrew Watchman thanked the panellists for their input and closed the session.

Closing speech

Filippo Poli emphasised the growing recognition that that accounting standards can have wider consequences and the expectation that wider consequences should be assessed and understood. He thought that fair value could bring relevant information because it was predictive in situations of uncertainty, however, the same uncertainty required handling fair values with care.

Summarising the main messages of the conference, he noted that fair value should not be expected to be exact. Consequently, the estimation was complex and understanding the process used is therefore key. Since small changes to inputs could result in huge differences in outcomes, preparers need to explain carefully the process, methodology and inputs used and users need to put in the necessary effort to fully understand the outcomes. He agreed with Henk Oosterhout that the term craftsmanship well described the estimation process.

He also agreed with Steven Cooper that there was no need to fear fair value and recalled that historical cost or fulfilment value also require many assumptions and judgement.

Filippo Poli closed the event and thanked Sir David Tweedie, the panellists, moderators and participants on EFRAG’s behalf.