



cutting through complexity

Fair Value Insights

September 2014

NZ IFRS 13 -
A long time coming...

ADVISORY
CORPORATE FINANCE

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WHAT IS KPMG'S FAIR VALUE INSIGHTS?

We aim to address relevant financial reporting issues from a valuation perspective.

KPMG New Zealand publishes *Fair Value Insights* to highlight relevant financial reporting issues from a valuation perspective. Our aim is to share insights on topical issues and challenges that are encountered as we assist our clients in navigating fair value reporting requirements.

Fair Value Insights is not intended to present an exhaustive commentary or analysis of accounting standards. For specific advice, we recommend you consult KPMG or your professional advisors.



Simon leads KPMG's financial reporting valuation practice and provides technical support to KPMG audit teams in New Zealand and the Asia Pacific region on fair value and impairment matters. Simon has significant international experience having been previously based in the UK, Japan, and the US. His US experience coincided with the implementation of the US GAAP equivalent of NZ IFRS 13 and he is able to share practical insights as this new standard is applied in New Zealand.





NZ IFRS 13 – A LONG TIME COMING – NO ALARMS BUT CARE STILL NEEDED.

Welcome to the latest edition of KPMG New Zealand's Fair Value Insights.

In this issue, we focus on NZ IFRS 13 Fair Value Measurement, which came into effect for reporting periods beginning from January 1st 2013. The first half of 2014 has seen the first tranche of preparers grapple with the practical interpretation of the new standard.

So what does initial experience tell us? Generally speaking, the transition has been relatively smooth. This reflects the fact that preparers have had a long run up to implementation (with the final form of the standard released in May 2011); and that the standard broadly codifies existing practice.

But as with any new guidance, the devil is in the detail. There has been much discussion on the new disclosure requirements, however the issues that we've found to have caused the most difficulty revolve around two core concepts that are central to fair value assessment; namely, the Unit of Account, Highest & Best Use:

- **Unit of Account** – The Unit of Account for accounting purposes may not always align to what would seem natural from a commercial perspective. The Unit of Account assessment can have a material impact on a range of value related considerations such as control and liquidity. Failure to properly assess the Unit of Account can lead to flawed valuation conclusions; and
- **Highest & Best Use** – in the absence of evidence to the contrary, the current use of an asset is often assumed to be its highest and best use. However, this is not a universal 'get out of jail free' card and evidence must be provided to demonstrate that the question has been given due consideration.

In addition, we have encountered a number of queries from clients grappling with the practical application of Credit/Debit Valuation Adjustments to their fair value assessments of financial assets and liabilities.

- **Credit/Debit Valuation Adjustments** – reporting entities are now required to explicitly consider the impact of credit risk (of both the counterparty and the reporting entity) when assessing the fair value of financial assets and liabilities. Difficulties arise due to the complex nature of the instruments under consideration and difficulties in sourcing market data to support credit profiles.

This edition of Fair Value Insights takes a closer look at these three concepts, and the challenges they present. We offer some practical takeaways for implementation. We hope you find it a useful and informative read.

Simon Wilkins

Partner, Financial Reporting Valuations
Corporate Finance – KPMG

UNIT OF ACCOUNT

Key to value – but counter-intuitive?

The Unit of Account refers to the level at which an asset or a liability is aggregated or disaggregated for recognition purposes. The concept itself is not new. It is already embedded in a number of existing accounting standards (including NZ IAS16, NZ IAS40, and NZ IFRS3).

NZ IFRS 13 highlights the fundamental importance of the Unit of Account when assessing fair value. The first question in any valuation should be to establish exactly what it is that is being valued. The answer cannot be found in NZ IFRS 13 itself – but instead lies in the standard that requires or permits fair value to be applied.

Unexpected outcomes can arise as the specified Unit of Account for accounting purposes is often counter-intuitive. Fair value may need to be determined on a basis that is inconsistent with the economic substance of the asset or investment. This highlights a long-standing conflict between the different perspectives; a commercial view of value does not always necessarily accord with accounting requirements.

A good example of this is an equity interest in a subsidiary or joint venture. The Unit of Account will determine whether the investment should be valued on the basis of

an aggregation of single individual shares; or of the total interest as a single block. This will influence the consideration of value-related factors such as liquidity, marketability and control.

Table 1 illustrates the interplay between Unit of Account and value considerations. If the Unit of Account is a single share (e.g. a share in an associate company under NZ IAS 28) then the fair value of the holding would be the total number of shares held, multiplied by the assessed fair value per share. The fair value per share will reflect a pro-rata allocation of the total equity value, calculated on a 100%, stand-alone basis; but excluding any synergistic benefits that might be available to a potential acquirer (a control premium). Specifically, any additional benefit of influence or control that is conferred by the specific terms of a particular Shareholders' Agreement, or by virtue of the size of shareholding, would not be reflected in a fair value assessment. This is because these are attributes of the holder, rather than attributes of the asset (in this case a single share). Similarly, a minority interest discount is not applicable because, in the accounting world, the proportionate returns theory would argue that the holder of a single share will benefit in proportion to a controlling shareholder behaving in an economically rational way.

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Table 1. Unit of Account

	Commercial considerations	Accounting considerations	
		Single Share	Total Interest
Control premium (acquisition synergies)	Depends on size of interest	No	Depends on size of interest
Minority interest	Potentially	No (1)	No (1)

(1) assuming legislation prohibits oppression of minorities.



Conversely, if the Unit of Account is the interest as a whole (such as a cash-generating unit under NZ IAS 36); then attributes of that interest need to be considered. For example, if the interest confers control, a premium may be applied when assessing fair value. This premium would be based on the synergies a market participant would be willing to pay on acquisition of the controlling investment.

When making an initial acquisition, the acquirer may have given scant regard to the Unit of Account. It will be thinking purely in commercial terms. The subsequent accounting may therefore come as a surprise, depending on how the fair value is assessed.

In the case of investments in subsidiaries, associates and joint ventures it appears that there is currently an accounting policy choice available in respect of Unit of Account (i.e. whether to view the Unit of Account as either the investment as a whole or the individual shares that make up the investment). The fair value attributes should be considered in making this election. If a whole-of-investment view is taken, differences between accounting and commercial considerations may be alleviated.

Other accounting standards may be more prescriptive as to what is to be adopted as the Unit of Account.

Unit of Account Example:

An entity holds a position in a listed company that is traded in an active market. If the entity sells its entire holding in a single transaction, the market's normal daily trading volume would not be sufficient to absorb the quantity held. That single transaction would affect the quoted price and result in the entity receiving a lower selling price.

Q. Should the entity adjust the fair value of that asset to reflect this?

A. No. The Unit of Account is a single share, therefore the fair value of the asset should continue to be measured as the product of the quoted price and the quantity held by the entity. NZ IFRS 13 specifically prohibits the application of a block discount; as it is an attribute of the holder, not the asset.

What is Fair Value?

Fair value is a market-based measurement, rather than an entity-specific measurement. It is assessed using assumptions that market participants would use in pricing the asset, including assumptions about risk. Accordingly, fair value in a transaction may also include adjustments to value which recognise attributes such as acquisition synergies, a premium for control, or a discount for a non-controlling interest. From an accounting perspective, however, fair value should not incorporate a premium or discount that is inconsistent with the Unit of Account.

Forthcoming IASB Guidance may impact current impairment practices

As noted above, the relevant Unit of Account for a cash-generating unit under NZ IAS 36 is the business as a whole (rather than the individual shares). Existing practice has therefore allowed us to include a control premium when assessing the fair value less cost-to-sell under this standard. In the case of a listed subsidiary, the quoted publicly-available price of a single share is often increased to reflect the incremental value a buyer of the business as a whole would be able to extract through acquisition synergies. Indeed such practice is consistent with takeover premia observed in market transactions. For example, on its acquisition of Fisher & Paykel Appliances, Haier paid a premium of over 70% relative to the stock price immediately preceding the announcement of the offer.

The IASB has been reviewing such practice on the basis that NZ IFRS 13 places an onus on maximising observable data; and in the case of a listed subsidiary, a "level 1" input (being the quoted share price) is available. While the IASB recognises that the quoted share price is not consistent with the Unit of Account, it is expected to recommend that the fair value of the listed subsidiary should be the quoted price (P) multiplied by the quantity of shares held (Q). The rationale for this approach is that the use of an unadjusted level 1 input results in a more objective and transparent measurement.

An Exposure Draft on the subject is expected soon, and the guidance is likely to prohibit an adjustment to the stock price to add a control premium. This would be a significant change to existing practice. It will mean that in an active market * a listed CGU will have a fair value based on its market capitalisation.

What's more, it is not clear whether this guidance will only apply to listed entities where a level 1 stock price is available. For unlisted subsidiaries, will a control premium still be allowed, or will practice be aligned?

Table 2 shows the impact on the valuation of applying a different Unit of Account to an 80% equity interest. In this example, the shareholder is able to extract additional economic benefits by virtue of the size of their interest.

Table 2. Fair Value Impact

	Unit of Account	
	Single share	CGU
Shareholding: 80%		
Fair value of Company		
Value to financial investor (standalone basis)	\$ 75m	\$ 75m
Control premium (synergistic benefits) 15%	-	\$ 11m
Fair value	\$ 75m	\$ 86m

*Active market – is defined in NZ IFRS 13 as "A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis". A position we regularly encounter is the notion that a lack of depth or liquidity in a listed stock means that it is not sufficiently active to provide a reliable measure of Fair Value. NZ IFRS 13 does not contemplate particular levels of liquidity – simply that the stock be traded with sufficient frequency and volume to provide pricing information on an ongoing basis. There are many public companies in New Zealand that may be thinly traded but would still meet the definition of an active market

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Increased impairment risk

The likely impact of this proposed guidance will be to decrease the fair value less costs-to-sell of listed CGUs; which in turn could lead to an increase in the risk of impairment. This will impact New Zealand more than many other countries – as a number of our smaller public companies are treated as single CGUs for accounting purposes.

There are also implications for other public companies that comprise more than one CGU. Consideration will need to be given to a reconciliation of total assessed fair value of the equity in all CGUs to the total market capitalisation of the listed entity. Although this is a check already performed by regulators and auditors, it is likely to increase in importance if the proposed change is adopted.

The impact could be even more widespread, depending on how the guidance is applied to unlisted companies and CGUs.



KPMG TAKEAWAYS

- ① The Unit of Account is critical to assessing fair value.
- ② Unit of Account guidance is found in the accounting standard that requires or permits fair value to be applied.
- ③ Unit of Account considerations may mean that fair value for financial reporting purposes may not always align with commercial thinking.
- ④ Forthcoming IASB guidance is expected to give priority to high quality (level 1) inputs over consistency with Unit of Account.
- ⑤ Preparers and users of financial statements will be able to make submissions on the proposed guidance when the exposure draft is issued.

HIGHEST AND BEST USE

Not new... but a fresh focus

NZ IFRS 13 adopts the concept of Highest & Best Use when assessing the fair value of an asset.

The concept of Highest & Best Use is not new, particularly in the area of real property valuation. The provisions of NZ IFRS 13 largely codify existing practice.

Highest & Best Use is the use by market participants that would maximise the value of the asset, or the group of assets and liabilities (e.g. a business). Rather than simply assuming that the existing use of the asset gives the best economic outcome, alternative uses of the asset also need to be considered.

Alternative uses need to meet certain criteria. Specifically when identifying the Highest & Best Use consideration needs to be given to whether the use is:

- Physically possible;
- Legally permissible; and
- Financially feasible.

For example; property rezoning or break clauses in lease agreements may allow a change in use that achieves a higher value. A particular land use may not be permitted under current zoning rules (although not legally prohibited) but if a market participant considers that a change in use can be achieved and makes commercial sense, then such a change will need to be factored into the fair value.

This approach is consistent with how real transactions are priced. Buyers of assets consider how they will use an asset after acquisition and will often look to ways of extracting more value than that achieved in its current use. Redevelopment of residential land to a more intensive use is a common illustration of how Highest & Best Use drives value.

In such circumstances, the fair value should incorporate the cost to convert the asset and obtain a different zoning permission, including the risk and uncertainty that such permission would not be granted. For example, converting a property from residential use to commercial use, the fair value should include all costs (such as legal costs, viability analysis, traffic studies) associated with re-zoning the land to the market participant's intended use.

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Current use likely to be Highest & Best Use

A particular question that appears to be raising some concern to companies that are subject to audit is how far the burden of proof extends. That is: in undertaking a fair value assessment, how much objective evidence needs to be gathered in order to demonstrate that the assumed use for the asset does indeed represent the asset's highest and best use?

Absent evidence to the contrary, an asset's current use is generally assumed to reflect Highest & Best Use (NZ IFRS 13 para 29). This is predicated on the idea that the owner of a particular asset has the greatest level of knowledge as to its potential value and will generally act in an economically rational manner, such as to optimise their returns from the asset. To assume otherwise would be to imply that the asset owner is using the asset in a value-destructive manner.

Such pragmatism is helpful. However, it is not a universal "get-out-of-jail-free card" and available evidence needs to be considered. For example, what is happening to similar assets in the market? Generally real estate appraisers keep track of changes in planned land and building usage. The behaviour of other market participants provides insights into the relative economic benefits of different usages.

Market participant use trumps current owner's plans

Highest & Best Use is determined from the perspective of market participants, even if the current owner intends a different use. To protect its competitive position, or for other reasons, an entity may intend not to use an acquired asset or it may intend not to use the asset according to its highest and best use. For example, an acquired trade name may be used defensively by preventing others from using it. Nevertheless, the entity shall measure the fair value of an asset assuming its highest and best use by market participants.

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Highest & Best Use Example:

A property developer has obtained consent to construct commercial (office and retail) space (on six contiguous titles).

At year end the fair value of the development land is assessed, having regard to its Highest & Best Use. The Unit of Account has been determined to be the individual titles. Prevailing economic conditions are such that commercial usage offers materially higher economic returns than residential usage.

An initial view of the facts would suggest that the entity should recognise each of the development land sites at fair value assuming commercial development as this is how a market participant would view similar land.

However, as a condition of the resource consent the developer is required to dedicate a portion of the development to high density residential apartments. The specific configuration of the site is not stipulated but 15% of the total development footprint must be residential.

The existence of the resource consent conditions presents a legal impediment to both the current owner, and any prospective future owner, from developing the entire site for commercial usage. The resource consent (and associated conditions) effectively attaches to the asset, rather than being specific to the holder.

On that basis the fair value assessment should recognise that 15% of the development land must be committed to residential development, this would give rise to a lower fair value than if there were no conditions attached to the resource consent.



KPMG TAKEAWAYS

- ① Absent evidence to the contrary, the current use of an asset will likely be the Highest & Best Use.
- ② Market information (or other factors) that suggest an alternative use must be given consideration.
- ③ The Highest & Best use should be determined from a market participant's perspective, regardless of the current owner's intended use.
- ④ If Highest & Best Use differs to existing use, the cost to convert the asset must be considered in assessing fair value.
- ⑤ Documentation (including valuations prepared by 3rd party appraisers) needs to appropriately evidence how Highest & Best Use has been addressed.

CREDIT VALUATION ADJUSTMENTS

Background

IFRS 13 requires that entities now explicitly consider the impact of credit risk when assessing the fair value of financial assets and liabilities.

This has given rise to the concept of credit valuation (CVA) and debit valuation adjustments (DVA) to derivative valuations.

For a derivative, a positive fair value on the balance sheet represents a 'receivable' from the counterparty and a negative fair value represents a 'payable' to the counterparty. For example, an interest rate swap can be a receivable or a payable at different points in time depending on the relative net present values of the estimated future cash flows payable by each party. Accordingly, the valuation of derivative instruments should reflect at any time the credit risk of both the counterparty (counterparty credit risk) and of the reporting entity (own credit risk). It also needs to incorporate the effect of collateral/margining and the impact of any netting agreements, if applicable, which may mitigate that credit risk (generally for a derivative transaction, the higher the level of collateral posted, the lower the level of credit risk adjustment needed).

Credit risk is the risk that a party will default before the maturity/expiration of the transaction and will be unable to meet

all contractual payments, resulting in a loss for the other party to the transaction. A valuation adjustment for credit risk reflects the amount at which this risk is valued by a market participant. The theory behind the adjustment is straightforward: a bank originating a derivative would distinguish between a credit 'risky' counterparty and a hypothetical credit 'risk-free' counterparty by charging the credit risky counterparty a spread for entering into the contract.

Similarly, if a bank were to sell an existing derivative asset to a market participant, then the market participant would, all other things being equal, pay less for a trade with a risky counterparty than for a trade with a riskless counterparty. The valuation adjustments to reflect the two-way risk of loss for the counterparty and the reporting entity/bank are commonly referred to as a credit valuation adjustment (CVA) – i.e. those reflecting the counterparty's credit risk – and a debit valuation adjustment (DVA) – i.e. reflecting an entity's own credit risk.

CVA tends to be most significant for derivative assets and DVA for derivative liabilities. However, under certain conditions both CVA and DVA adjustments may be relevant for both derivative assets and liabilities (as shown in the illustrative example on the following page).



Valuation methodologies

There are three common methodologies used in order to calculate the credit adjustment, ranging from a simplistic discount curve adjustment approach focusing upon current exposure, to the more complex and sophisticated which simulate potential future exposure due to market rate changes (Swaption and Monte Carlo simulation approaches).

The appropriateness of the model will depend upon the characteristics of the transaction such as the tenor and the instrument complexity. Longer dated derivatives for example have a greater propensity to move from an in-the-money (ITM) asset position to an out-of-the-money (OTM) liability position, therefore a methodology that draws upon the potential future exposure is most appropriate in assessing the credit impact.

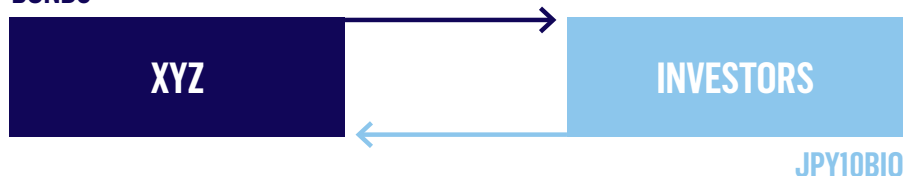
Example

XYZ Corporate raises JPY funding through the issuance of bonds, then enters into two cross-currency interest rate swaps with a remaining term of thirteen years to swap the JPY to its local functional funding currency.

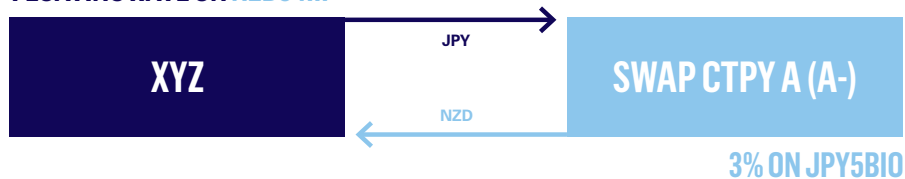
The company pays the variable index on NZD64m whilst receiving 3% on JPY5bio on each swap. The swaps are transacted with two different swap counterparties; A has a credit rating of A- whilst counterparty B has a credit rating of AA-, i.e. an improved credit worthiness outlook.

Table 3 shows the impact of credit risk upon the valuations of the cross-currency interest rate swaps transacted with different counterparties and different credit profiles. The valuations have used the potential future exposure approach; the key observation is that a long dated position that is currently reported as a liability may incur a credit charge increasing that liability reflecting the probability that the swap will move to an asset position in the future. It should also be observed that the credit adjustment is lower when the credit worthiness of the swap counterparty improves, i.e. swap counterparty B has a AA- rating whilst counterparty A has a lower rating of A-. (Standard & Poors rating scale)

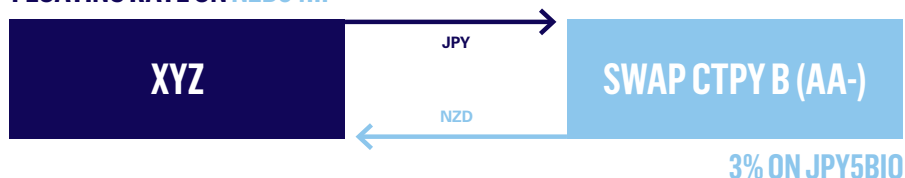
BONDS



FLOATING RATE ON NZD64m



FLOATING RATE ON NZD64m



**Table 3. Fair Value of swaps in XYZ's books**

As at 31 December 2013	Swap 1 (Counter Party A)	Swap 2 (Counter Party B)
Counterparty credit rating	A–	AA–
Present value before credit risk	(9,791)	(9,791)
Credit Valuation Adjustment (CVA)*	(972)	(523)
IFRS 13 Fair Value	(10,763)	(10,314)

* Note: the credit valuation adjustment incorporates both XYZ's own credit risk and the credit risk of the respective counterparties.

Challenges

Assessing the impact of credit risk on derivative valuations can be challenging and the information required is not normally provided by the counterparty or bank. The complexity arises from the nature of the products, coupled with difficulties in sourcing market data to support credit profiles, in addition to system capabilities. All of these present hurdles that we see a number of firms struggling to overcome.

KPMG TAKEAWAYS

- ① The impact of credit needs to be reassessed each reporting period; key inputs in assessing the impact of credit are subject to change, not least counterparty credit spreads, valuation methodology, terms of the derivatives held and collateral.
- ② The impact of collateral held and the nature and purpose of any collateral agreements needs to be fully understood – i.e. some collateral agreements may cover only one party for non-performance risk.
- ③ The price of credit is a key input in deriving CVA/DVA. Obtaining objective information about the price of credit can present challenges.
- ④ The incorporation of a CVA or DVA can potentially lead to hedge ineffectiveness in any cash flow or fair value hedge relationship. The rationale being that any change in the fair value of the hedging derivative associated with creditworthiness and reflected through a CVA/DVA adjustment would not ordinarily be reflected in the hedged item.

ABOUT KPMG CORPORATE FINANCE & VALUATIONS

At KPMG we are committed to providing effective and specialist valuation advice to the New Zealand market. Our team offers tried and tested local and international skills to guide you through challenging valuation scenarios.

We take care to balance our technical methodologies with 'real world' inputs and hence draw on our proprietary transaction, royalty and impairment databases when delivering advice.

We find that valuations are triggered by three drivers:

- » Changes in ownership structures e.g. sales, acquisitions, strategic planning, dispute management and pricing.
- » Capital management e.g. capital raising, investment appraisal and restructuring.
- » Regulatory environment e.g. purchase price allocation, impairment testing, independent appraisal reports, tax valuations and share schemes.

Whatever the cause of your requirements, we take a collaborative, cross disciplinary approach to provide you with commercial, rigorously prepared valuation advice.

If you would like to know more about the corporate finance services we offer please call us on **09 367 5800**

Individual partner contact details are over the page.

OUR CORPORATE FINANCE SERVICES INCLUDE

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Are you focussed on maximising the sale value of your business?

We regularly act as lead adviser providing guidance on: deal timing, sourcing and contacting likely buyers, valuation, bid management and negotiating key terms.

Acquisition Advice

Are you looking to secure a target asset?

We review whether the target fits your strategic direction, offer valuation guidance, assist in formulating your offer, perform due diligence and negotiate your offer to completion.

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Do you need unbiased and objective input on MBO feasibility?

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Are you looking for a trusted partner in this area?

We provide lead financial advisory assistance in complex and high profile public takeovers and mergers across the capital markets. This includes both those agreed between the parties, and those which are unsolicited or hostile.

Any questions? If you have any questions on NZ IFRS 13 Fair Value Measurement, or need advice on practical aspects of implementation, our team would be happy to help.

Please feel free to contact:



Simon Wilkins

Partner, Financial Reporting Valuations
Corporate Finance
T: +64 (09) 363 3480
E: swilkins1@kpmg.co.nz



Ceri Horwill

Partner
Financial Risk Management
T: +64 (09) 367-5348
E: cerihorwill@kpmg.co.nz



Simon Lee

Technical Director
Accounting Advisory Services
T: +64 (04) 816 4678
E: sdlee@kpmg.co.nz

kpmg.com/nz