Ukraine-Russia conflict: What are the implications for fair value measurement?

7 April 2022

What’s the issue?
The war in Ukraine has significantly affected individuals, economic activity and financial markets on a global scale. The war and the sanctions imposed have led to a steep jump in commodity prices (mainly energy, metals and agricultural commodities) and supply chain disruptions. Consequently, it is not only companies with operations (or assets) in Russia, Belarus or Ukraine, or those trading with counterparties in these countries, that have been significantly affected. Other companies may be indirectly affected by commodity price inflation, shortages in supplies and a weaker economic environment – e.g. the automotive, food manufacturing, agriculture and transportation sectors.

Fair value is a market-based measurement – it is measured using assumptions that market participants would use. Determining fair value in these circumstances has become more challenging due to the higher uncertainty and elevated risks.

For reporting periods ending after 24 February 2022 (the date Russia invaded Ukraine), the war is a current-period event that should be reflected in determining the fair value of assets (and liabilities) such as debt and equity securities and investment property, or when testing cash-generating units for impairment using fair value less costs of disposal. Because fair value is a market-based measurement (i.e. it is measured using assumptions that market participants would use), this will become more challenging due to greater risks and uncertainty.

Getting into more detail
Fair value is an exit price – the price received to sell an asset (or the price paid to transfer a liability) to a market participant. It is measured using assumptions that market participants would use in pricing the asset (or liability). A company’s intention to hold an asset or its own value expectations are therefore not relevant in measuring fair value. [IFRS 13.2-3]

Under IFRS 13 Fair Value Measurement, a quoted price in an active market provides the most reliable evidence of fair value and, if one is available, then IFRS 13 requires that it is used, even if the market is highly volatile. [IFRS 13.77]

A quoted price may be ignored only if the transaction underlying it is not orderly – e.g. a forced liquidation or a distressed sale. [IFRS 13.B44(a)]

As a result of the war and related events, there may be a significant decrease in the volume or level of activity in the market for an item compared with its normal market activity. This decrease on its own is not necessarily indicative that a transaction or a quoted price does not represent fair value, or that a transaction in that market is not orderly. If a company concludes that the volume or level of activity has significantly decreased, then further analysis of the transactions or quoted prices may be required. However, a company does not disregard market

“The fair value of an asset (or liability) should reflect market conditions at the measurement date. This has become more challenging, in particular for investments and assets directly affected by the war or the sanctions imposed.”

Eiichi Fujita
Head of DPP Accounting
KPMG AZSA LLC
prices unless those prices are from transactions that it determines are not orderly. If a company determines that a transaction or quoted price does not represent fair value, then the company needs to adjust that price if it is used as a basis for determining fair value. In addition, if a company concludes that there is a significant decrease in the volume or level of activity, then it may be appropriate to change its valuation technique or to use multiple valuation techniques to measure the fair value of an item. [IFRS 13.B37-38, 40, Insights 2.4.480.30]

To determine the fair value of securities for which a quoted price is no longer available due to the suspension of trading, valuation techniques need to be used – ones that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. If information is available on transaction prices in the secondary market for identical or similar securities, then it can be used only to the extent that the transactions are orderly. [IFRS 13.3]

Changing the valuation technique used or using additional valuation techniques may change the categorisation of the fair value measurement within the fair value hierarchy.

**Equity securities**

**Reflecting market conditions and risks at the measurement date**

When applying valuation techniques under the income approach, the following are examples of inputs that may need to be updated in estimating future cash flows:

- sales: sanctions, capital controls and reputational damage may hinder a company’s ability or willingness to trade with counterparties in Russia;
- growth rates and inflation rates;
- commodity prices and foreign exchange rates;
- profit margins; and
- expected capital expenditure to enhance or improve the business (or an asset) and the associated benefits.

Another key input under the income approach is the discount rate, which should reflect the time value of money and the risks specific to the asset or business. Recent events may have had a significant impact on the following risks.

- **Country risk:** A premium that takes into account the additional risk associated with generating and incurring cash flows in a particular country (e.g. Russia, Ukraine).
- **Forecasting risk:** Fair value measurements should reflect the greater uncertainty in making economic and financial forecasts in the near term, due to the difficulty in forecasting the magnitude of the impact of the war and sanctions imposed.
- **Illiquidity risk:** An additional premium that takes into account the difficulty of being able to sell an investment.

Significant judgement may be needed to quantify risk premiums and other adjustments for these risks. Furthermore, nominal (risk-free) discount rates incorporate inflationary expectations, which have been surging due to the impact of the war on commodity prices. [IFRS 13.B14]

The rate used to discount cash flows should not reflect adjustments for factors that have been incorporated into the estimated cash flows and vice versa. Otherwise, the effect of some assumptions will be double counted. [IFRS 13.B14]

**Considering which approach to use**

Two approaches can be used to project cash flows – the traditional approach, which uses a single cash flow projection, and the expected cash flow approach (ECF), which uses multiple, probability-weighted cash flow projections. [IFRS 13.B12, Insights 2.4.160]
Using the ECF approach (rather than the traditional approach) may be useful in identifying and modelling various potential outcomes. For example, modelling different scenarios in determining the value of operations suspended in Russia – e.g. seizure of assets.

**Loans and debt securities**

When estimating the fair value of a debt instrument, some of the key factors to consider include: the currency of the instrument, its credit risk, illiquidity risk, interest rate risk and inflation risk. These factors should reflect the issuer’s exposure to the conflict and the knock-on effects. [Insights 2.4.997.50]

Credit rating agencies have downgraded the credit rating of companies adversely affected by the war to ‘junk’ status. The fair value of debt instruments needs to reflect the heightened credit and currency risk, as well as the increase in illiquidity for those debt securities for which trading has been suspended. Additionally, if capital control or other restrictions exist (e.g. payment of principal and interest to a limited-access account restricting an investor’s ability to withdraw money), then these need to be reflected in the fair value if market participants would take them into account in pricing the debt instrument.

Some securities may have direct and indirect exposures to the conflict. For example, asset-backed securities (ABSs) backed by aircraft leases may have direct exposure through leases to Russian airlines and they may also have indirect exposure through the effect on other airlines’ creditworthiness from higher oil prices, a key component of costs.

The effects on a security’s value may be magnified by the leverage of an issuer – e.g. companies with higher leverage generally have less capacity to absorb business shocks. This means that they may have a higher risk of financial distress – e.g. because of the crisis there is a greater risk of a decline in operating performance, which could cause a financial covenant breach.

More generally, loans and debt securities that have a fixed interest rate and are not indexed to inflation are exposed to interest rate and inflation risk.

**Derivatives**

In practice, companies often determine an explicit credit valuation adjustment (CVA) to incorporate counterparty credit risk and an explicit debit valuation adjustment (DVA) to incorporate own non-performance risk, as necessary, into the fair value measurement of derivatives. Incorporating these adjustments is often significant for non-centrally cleared over-the-counter (OTC) derivatives. These adjustments are affected by the probability of default, the credit exposure at the time of default and the loss given default. Therefore, they may need to be updated to reflect the impact of the conflict on these factors. [Insights 2.4.460.40–60]

**What do you need to disclose?**

Disclosures related to fair value measurement are likely to be a focus area for regulators. Preparers are expected to explain how the war in Ukraine has affected significant judgements and estimation uncertainty – e.g. the assumptions underlying fair value measurement.

**Annual reports**

Given the impact of economic uncertainty on forecasting cash flows and other unobservable inputs used in valuation techniques (e.g. certain risk-adjusted discount rates), companies may need to provide sensitivity disclosures – together with disclosure of the key assumptions and judgements made by management – to enable users to understand how fair value has been determined. These disclosures are required under both IFRS 13 and IAS 1 *Presentation of Financial Statements*. IFRS 13 also contains specific disclosure requirements when amounts are transferred into Level 3 of the fair value hierarchy. [IFRS 13.93(e)(iv), 93(h), IAS 1.125, 129]
Interim reports

IAS 34 *Interim Financial Reporting* requires companies to provide many of the IFRS 13 disclosures on fair value measurements of financial instruments, including the sensitivity disclosures and significant transfers between the levels in the fair value hierarchy. Additionally, IAS 34 requires companies to explain events and transactions that are significant to an understanding of the changes in a company’s financial position and performance since the last annual reporting date. Therefore, fair value disclosures are required if they are material to an understanding of the current interim period. This may be the case when fair values change significantly. ([IAS 34.15, 16A(iii)](https://www.ifrs.org/))

**Actions for management**

Consider whether:

- the valuation reflects market participants’ assumptions based on information available and market conditions at the measurement date;
- the technique used maximises the use of relevant observable inputs and minimises the use of unobservable inputs;
- cash flow projections have been updated and the valuation incorporates the necessary risk premiums;
- unobservable inputs have become significant, which would result in a Level 3 categorisation and need additional disclosures; and
- disclosures about the key assumptions, sensitivities and major sources of estimation uncertainty need to be enhanced.

References to ‘Insights’ mean our publication *Insights into IFRS*®