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**EXTERNAL AUDIT  
AND FAIR VALUE  
MEASUREMENTS**

**FrancoAngeli**

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# PREFACE

Fair value measurements represent a dramatically increasing percentage of accounting estimates in the financial statements, either under the IAS/IFRS and under the local GAAP of most European Countries including Italy. Fair value accounting is in fact spreading from public firms to private firms, as a consequence of the implementation of European Union directives on accounting harmonization.

This book addresses the external audit procedures and techniques applied to complex fair value measurements in the current market environment. Fair value value measurements are often addressed to as hardly verifiable and auditable estimates. Yet, they must be audited and the international auditing standard directly address the intrinsic estimation uncertainty and the efforts the auditor must make.

Recent audit experience highlighted the difficulties that occur in reviewing fair value measurements, when market information is either not available or sufficient information is difficult to obtain. Many regulatory authorities and other practitioners' organizations have been considering which is the best way to assist preparers of financial statements and their auditors to deal with these difficulties. This book attempts to contribute to this debate and a twofold objective. Firstly, it jointly examines key fair value measurements and prescriptions of the international auditing standards. Secondly, it analyses how audit standards can be effectively applied to the review of fair value measurements and which are the most critical issues.

The first section studies the IFRS 13 focussing on the audit of the different fair value levels and on the audit of the valuation techniques. The second section deals with financial instruments, exploring in-depth the fair value measurements of financial assets and liabilities and their audit review. The third section focuses on the audit of fresh start accounting under the US GAAP.

Fresh start accounting is a highly complex task, as it requires measuring all the assets and liabilities at fair value in the fresh start financial statements.

The conclusion section emphasizes how external audit is crucial to limit the managerial accounting discretion. International standards on auditing provides general guidelines, needing significant effort to be applied to the review of fair values, under either the IAS/IFRS and the US GAAP. In this respect, our work suggests that international auditing standards demand further development to codify existing knowledge on the audit of fair value measurements, as well as to provide improved guidance to auditors.

\* \* \*

The Authors wish to thank Prof. Luciano Marchi for his scientific guidance in the investigation of the external audit field. The Authors also wish to thank Prof. Stefano Marasca, Giuseppe D'Onza and Marco Allegrini for their valuable advice and support. The responsibility of the book contents is solely of the Authors. Giulio Greco acknowledges the financial support of the SIR program of the Ministry of University, Education and Research (MIUR) and of the PRA program of the University of Pisa.

The Authors

Pisa, 1 march 2018

# 1. AUDIT OF FAIR VALUE MEASUREMENTS UNDER IFRS 13

by *Federica De Santis*

## 1.1. Overview of the IFRS 13

The last decades have witnessed a fundamental change in financial reporting approach, consisting in a trend that leads away from the historical cost criterion, which represented the cornerstone of traditional financial accounting, toward fair value accounting. Fair value, therefore, has become the basis of measurement and reporting for an increasing amount of financial and non-financial assets and liabilities (Bratten et al., 2013)<sup>1</sup>. Referring both to International Financial Reporting Standards (IFRS) and to the Generally Accepted Accounting Principles (U.S. GAAP), indeed, one can see that an growing amount of financial statement information must be reported to or disclosed at fair value<sup>2</sup>.

Over the past quarter of century, indeed, it became apparent that the traditional paradigm of “bricks-and-mortar” business and consequently the related cost-based accounting were not reflecting anymore the current economic environment, characterized by the predominance of entities whose value lays mostly in their intangible capital rather than on their inventory, equipment and plan. Fair value, therefore, was considered the best criterion in representing the actual value of an entity, able to provide also more relevant and transparent information to financial statement users. Information transparency and usefulness, indeed, constitute the most relevant charac-

<sup>1</sup> Bratten, B., Gaynor, L. M., McDaniel, L., Montague, N. R., & Sierra, G. E. (2013). The audit of fair values and other estimates: The effects of underlying environmental, task, and auditor-specific factors. *Auditing: A Journal of Practice & Theory*, 32(sp1), 7-44.

<sup>2</sup> Quagli, A., & Avallone, F. (2010). Fair value or cost model? Drivers of choice for IAS 40 in the real estate industry. *European Accounting Review*, 19(3), 461-493.

teristics of well-functioning capital markets as it helps investors in making informed decisions about resource allocation (Zyla, 2013)<sup>3</sup>.

Nonetheless, fair value accounting also poses relevant challenges for regulators, standard setters, reporting entities and statutory auditors, as it often requires high-level expertise and the exercise of significant judgment, also giving space for management's bias. Fair value accounting and its misapplication, in fact, played a primary role in the largest accounting scandals and corporate frauds in the early 2000s, and came under severe scrutiny again in the aftermath of the global financial crisis that commenced in 2007 (Hermanson et al., 2017)<sup>4</sup>. Several authors have underlined that the inherent uncertainty of fair value estimates leaves rooms for management's fraudulent manipulations causing an impairment of estimates' reliability, which negatively affects financial reporting transparency and its usefulness to capital market participants (Glover et al., 2016)<sup>5</sup>.

As a response, regulators and standards setter over time have proposed several responses in order to restore the reliability of accounting estimates and, in general, to restore public trust on financial reporting as a whole<sup>6</sup>. In this respect, since auditors are "the arbiters of reliability of financial reports" (Griffith et al., 2015)<sup>7</sup>, it becomes of crucial importance to guarantee high-quality audit activities, mostly in the area of accounting estimates. The effectiveness of fair value audit, furthermore, is affected not only by the auditors' degree of expertise on the steps and procedures necessary to verify and attest to fair value estimates, but also by the knowledge that statutory auditors have about how the client firms' management develop fair value estimates,

<sup>3</sup> Zyla, M. (2013). Fair Value Measurement (ed.).

<sup>4</sup> Hermanson, S. D., Kerler, W. A., & Rojas, J. D. (2017). An Analysis of Auditors' Perceptions Related to Fair Value Estimates. *Journal of Corporate Accounting & Finance*, 28(3), 18-37.

<sup>5</sup> Glover, S. M., Taylor, M. H., & Wu, Y. J. (2016). Current practices and challenges in auditing fair value measurements and complex estimates: Implications for auditing standards and the academy. *Auditing: A Journal of Practice & Theory*, 36(1), 63-84.

<sup>6</sup> Apart from specific regulatory intervention aimed at restoring public trust in financial reporting, such as the Sarbanes-Oxley Act in the US and the Directive 2006/43/CE in the European Union, standards setters worldwide have progressively improved accounting standards related to fair value estimates. To date, the primary sources of guidance on this topic refer to IFRS 13 – *Fair value measurements*, issued by International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820 – *Fair value measurements*. Since 2002 IASB and FASB are also jointly involved in a project to converge U.S. GAAP with IAS/IFRS because they recognized the need for a common set of accounting standards able to enhance financial reporting quality and comparability worldwide.

<sup>7</sup> Griffith, E. E., Hammersley, J. S., & Kadous, K. (2015). Audits of complex estimates as verification of management numbers: How institutional pressures shape practice. *Contemporary Accounting Research*, 32(3), 833-863.

including the potential pitfalls and biases inherent in preparing them (Martin et al., 2006)<sup>8</sup>.

The IFRS 13 represents the reference standards in developing fair value measurements, and its aim consists in (a) providing a generally applicable definition of fair value; (b) defining a framework for measuring fair value and (c) requiring reporting entities to provide specific disclosure about fair value measurements.

One first element that can be inferred by analysing the scope of IFRS 13 refers to the fact that the standard does not establish “*when*” an asset, liability or equity instrument must be measured at fair value. It instead provide guidance on “*how*” to develop fair value measurements when it is required by other international accounting standards. In fact, “this IFRS applies when another IFRS requires or permit fair value measurements or disclosures about fair value measurements” (IFRS 13, par. 5). Table 1 presents a brief overview of significant items that call for the use of fair value consistently with the IFRS 13.

*Table 1 – Significant items that are required to be measured at fair value*

Reference standard	Item (asset, liability or equity instrument)
IFRS 3	Assets acquired and liabilities assumed due to a business combination
IAS 39 / IFRS 9	Financial instruments and financial guarantee contracts
IFRS 5	Noncurrent assets held for sale and discontinued operations
IFRS 10	Consolidated financial statements – investment in subsidiaries by investment entities
IFRS 15	Revenue from contracts with customers
IAS 16	Property, plant and equipment – revaluation model and exchange of assets
IAS 18	Employee benefits – postemployment benefits obligations
IAS 28	Investments in associates and joint ventures held by mutual funds and similar entities
IAS 36	Impairment of assets – nonfinancial assets
IAS 38	Intangible assets – revaluation model
IAS 41	Agriculture – biological assets

The IFRS 13 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between

<sup>8</sup> Martin, R. D., Rich, J. S., & Wilks, T. J. (2006). Auditing fair value measurements: A synthesis of relevant research. *Accounting Horizons*, 20(3), 287-303.

*market participants at the measurement date*” (IFRS 13, par. 09). According to the quoted definition, therefore, fair value constitutes a market-based measurement rather than an entity-specific one, as it explicitly refers to a price (and, particularly, an exit price) received or paid in the event of a transaction ordinarily taking place between market participants.

Since the IFRS 13 aims at providing a generally applicable definition of fair value and a framework for its measurement, without providing any guidance about when measurement should be made (whether at initial recognition or in subsequent evaluations), nor to what accounting subject it must be applied, the proposed definition focuses both on assets and liabilities, which represent the primary subject of accounting measures, but can also be applied to an entity’s own equity instruments measured at fair value, i.e. any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

The analysed standard, however, also provides specific exceptions to fair value measurement and disclosure requirements. The IFRS 13, indeed, do not apply to the following accounting subjects:

- share-based payment transactions that are within the scope of IFRS 2;
- leasing transactions, which falls within the scope of IAS 17;
- measurements similar to fair value but that are not fair value (e.g. the net realisable value of inventories according to IAS 2 or the assets’ value in use determined according to IAS 36).

Moreover, exceptions to disclosure requirements are provided for the following:

- plan assets measured at fair value according to IAS 19;
- retirement benefit plan investments measured at fair value according to IAS 26;
- assets for which recoverable amount determined according to IAS 36 is fair value less costs of disposal.

Stemming from the above, the main elements that characterise the proposed definition of fair value may be summed up as follows.

### *The accounting subjects of fair value measurements*

As previously underlined, IFRS 13 applies to assets, liabilities and equity instruments whose valuation at fair value or disclosure about fair value are required or permitted by another IFRS. Despite the general definition provided, fair value measurement refers to a particular asset or liability about which reporting entities must carefully determine the appropriate *unit of account*, as well as its peculiar characteristics in terms of *condition*, *location*, and presence of any *restrictions* to its use or sale.

The unit of account, indeed, is “*the level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes*”. In this respect an asset or a liability might be considered on a stand-alone basis (e.g. a financial instrument or a warranty liability) or as a group of assets, a group of liabilities or, finally, a group of assets and liabilities (e.g. a business or a cash-generating unit).

Referring to the characteristics of the assets or liability being valued, reporting entities should distinguish between those that are specifically related to the subject of measurement and those that are instead specific to the asset’s owner. While the former would be taken into account by market participants in determining the price of the asset in the event of a transaction, the latter instead would not be transferred to the market participant. In this respect, the exit price should be adjusted considering:

- any costs necessary to lead the asset or the liability from its current condition to the condition usually required by market participants for concluding a transaction;
- any transportation costs, whether location is an inherent characteristics of the asset or liability (e.g. commodities);
- any limitations to the sell or use of the asset or liability (e.g. the measurement refers to restricted shares and the restriction cannot be removed, so that it will be transferred to other market participants).

#### *The transaction and the reference market*

The IFRS 13 assumes that when selling an asset or transferring a liability at the measurement date market participants are involved in orderly transaction, i.e. a transaction that is not forced (e.g. one of the market participants is a distressed entity or in forced liquidation) and exposed to the market for a sufficient period before measurement date to allow usual marketing activities for such assets or liabilities.

As fair value measurement is, by its own definition, a market-based valuation, it is of great importance for reporting entities to properly identify the market in which orderly transactions for selling assets or for transferring liabilities would take place.

The IFRS 13 starts from the assumption that assets and liabilities are exchanged in their *principal market*, that represents the market in which the highest volume and level of activity for a given asset or liability is realized, regardless of the entity-specific volume of activity. In order to be considered for fair value measurement purposes, the principal market must be accessible by the reporting entity at the measurement date. Accessibility, however, does not necessarily means that the reporting entity would be actually able to

conclude the transaction on measurement date (e.g. restrictions might impede to sell an asset or to transfer a liability).

Only when it is not possible to identify a principal market (i.e. because there are multiple markets with the same level of activity, or because the existing principal market is not accessible at the measurement date), fair value measurement is assumed to represent the result of a transaction in the *most advantageous market*. The most advantageous market consists in the market that maximises the receivable amount from selling a given asset or minimises the amount paid for transferring a liability, after taking into account transaction and transportation costs. The parameters employed in identifying the most advantageous market do not correspond to those employed in measuring fair value. In fact, while fair value derives from the difference between transaction price and transportation costs (without considering transaction costs), in identifying the most advantageous market both transportation and transaction costs are detracted from transaction price. The most advantageous market must be accessible to the reporting entity at the measurement date too, under the same conditions mentioned above for the principal market.

Moreover, in identifying the principal (or the most advantageous) market, the IFRS 13 imposes to consider also the reporting entity perspective, because accessible markets for selling the same asset or transferring the same liability may differ from one entity to another depending on its specific business and industry.

Referring to the market concept, the IFRS 13 points out that reporting entities should take into account, without undertaking an exhaustive search, all the available information in order to identify principal market. Unless contrary evidence, it is presumed that the principal market for an asset or a liability is that in which entities normally enter in order to sell the asset or to transfer the liability.

When it is not observable neither a principal nor a most advantageous market, the IFRS 13 prescribes that fair value measurement should be based on an *assumed transaction* taking place on the measurement date, “considered from the perspective of a market participant that holds the asset or owes the liability” (IFRS 13, par. 21).

### *Market participants*

When measuring the fair value of an asset or a liability an entity should take into account the assumptions that market participants would use in pricing such asset or liability, assuming that they are acting in order to maximise their economic interest. It is assumed, moreover, that market participants:

- are independent of each other (i.e. they are not related parties<sup>9</sup>);
- have reasonable understanding about the asset or liability and of the transaction using all available information, including that obtainable through usual due diligence efforts for similar transactions (i.e. they are knowledgeable);
- are able to enter into a transaction for the asset or liability;
- are willing and motivated, but not forced or compelled, to enter into a transaction for the asset or liability.

The IFRS 13 also underlines that, when considering market participants, the reporting entity does not have to refer to specific market participants. Rather, it should identify the general characteristics of potential market participants considering the asset or the liability to be exchanged, its principal (or most advantageous) market and the market participants with which the entity would enter into a transaction in that market. The application guidance of IFRS 13 helps entities in identifying market participants' assumptions, focusing, among others, on transportation costs or other costs specifically related to the conditions of the asset or the liability and the level of transaction risk (IFRS 13, par. BC59).

### *The price*

Price constitutes the cornerstone of fair value measurements and it represents the exit price received for selling an asset or paid for transferring a liability in the principal (or most advantageous) market at the measured date under current market conditions, “*regardless of whether that price is directly observable or estimated using another valuation technique*” (IFRS 13, par. 24). Consistently, when neither the principal nor the most advantageous market is observable, the IFRS 13 prescribes to estimate the fair value of an asset or a liability on the basis of an assumed transaction that takes place on the measurement date, considered from the perspective of a market participant that hold the asset or owes the liability.

The price derived from the market (whether principal or the most advantageous) should not be adjusted depending on transaction costs, because they are related to the specific transaction, rather than to the asset or liability being exchanged. Transaction costs, however, do not include transportation costs that may instead constitute the basis for an adjustment of the transaction price if the location is an inherent characteristic of the asset or the liability being exchanged (as it is for commodities).

<sup>9</sup> The definition of related parties is provided by IAS 24 – *Related Party Disclosure*.

After describing the constituent elements of the fair value definition in order to provide guidance to reporting entities, IFRS 13 also gives indications about the measurement of fair value in some peculiar cases. Specifically, guidance is offered about determining fair value of:

- non-financial assets;
- liabilities and entity's own equity instruments; and
- financial assets and liabilities with offsetting positions in market risks or counterparty credit risks.

For such items, in fact, quoted market prices are often not available and additional guidance is therefore needed, due to the fact that reporting entities might should measure fair value according to different premises for valuation.

#### *Fair value of non-financial assets*

The measurement of fair value for non-financial assets poses further requirement that is not imposed for financial instruments, liabilities and equity instruments. The standard, indeed, states that fair value measurement for a non-financial asset must take into account the ability of a market participant to generate economic benefits by using that asset in its "highest and best use" or by selling it to another market participant that would use the asset in its highest and best use, i.e. in such a way that it would maximise its value.

The highest and best use of a non-financial asset is thus an economic concept, consisting in employing this asset in such a way that its value would be maximised, whether using the asset on a stand-alone basis, or in combination with a group of assets or a group of assets and liabilities (such as a business).

The highest and best use of a non-financial assets encompasses three main assumptions about the use of that asset. Its employment, indeed, must be physically, legally and financially possible. When pricing the asset, therefore, market participants would consider its physical characteristics (e.g. dimensions, location, etc.), the presence of any legal restrictions on its use (e.g. the zoning regulations applicable to a property) and the adequacy of that asset (provided that it is both physically and legally usable) in generating the required return on investment, in terms of income or cash flows.

Also in this case, therefore, fair value constitutes a market-based measurement. The reporting entity, in fact, must determine the highest and best use of non-financial assets adopting the perspective of market participants, even if the entity intends to use these assets in a way that differs from its highest and best use. However, it is presumed that the owner entity is currently using the asset according to its highest and best use, unless the market or other factors suggest that a different utilisation would maximize the asset's value.

Interestingly, the IFRS 13 allows to consider as the highest and best use of a non-financial assets also a “defensive value”. An entity, in this case, would acquire an asset with the aim of not using it at all in order to protect its competitive position (e.g. an entity acquires an intangible asset, such as a patent, to use it defensively preventing competitors from using it).

The assumptions about the highest and best use of non-financial assets (whether on a stand-alone basis or in combination with other assets and/or liabilities) also determine the valuation premise used to measure these assets’ fair value. Therefore, if the highest and best use of a non-financial asset is on a stand-alone basis, its fair value is the price that would be received in a current transaction to sell the asset to market participant that would use the asset on a stand-alone basis. Otherwise, the fair value is represented by the price that the entity would receive in a current transaction by selling the asset to market participants, assuming that this asset would be used in a group assets or in a group of assets and liabilities, provided that these assets and liabilities are already available for market participants.

However valuation of non-financial assets should be consistent with the unit of account imposed by the specific IFRS that requires or permits its measurement at fair value, that might be an individual asset even when for fair value measurement purposes it is assumed that the highest and best use of that assets is in combination with other assets and/or liabilities. In these cases, the IFRS 13 requires to consider the specific circumstances, adjusting the fair value resulting from the adoption of the highest and best use criterion.

#### *Fair value of liabilities and of entity’s own equity instruments*

Measuring the fair value of a liability (whether financial or non-financial), or of an entity’s own equity instrument (e.g. equity interests issued as remuneration in a business combination) starts from the following assumptions:

- the liability (the equity instrument) is transferred to a market participant at the measurement date;
- the liability would not be settled with the counterparty or otherwise extinguished on the measurement date and the transferee would be required to fulfil the obligation;
- the equity instrument would not be cancelled or otherwise extinguished on the measurement date and the transferee would take on the rights and responsibilities associated with the instrument itself.

Consistently with fair value definition, the best indication of fair value for liabilities or equity instruments are quoted prices for transferring identical items in active markets. However, quoted market prices are not always available, especially if liabilities and equity instruments are not transferable due to legal or

contractual constraints. In these cases, IFRS 13 suggests to refer to quoted market prices available in an active markets for identical instruments that are held by another party as assets (which might be the case of corporate bonds).

The reporting entity, in this case, might need to adjust the quoted market prices of identical items held by another party as an asset in order to take into account specific characteristics of that asset that are instead not applicable for the liability or equity instrument to be valued. IFRS 13, however, allows to adjust market prices only in the following hypotheses:

- the observable quoted market price refers to similar (but not identical) liabilities or equity instruments held by another party as an asset, whose characteristics are somehow different from those of the item to be valued (e.g. different credit quality of the issuer);
- the unit of account of the asset is different from that of the liability or the equity instrument under valuation. For example, the reference asset's price reflects a combined price for a package that comprises both the issuer's liability and a third party credit enhancement, while the unit of account for fair value measurement purposes is represented only by the issuer's liability. Market price, in this case, should be adjusted in order to eliminate the effect of the third party credit enhancement. However, the converse (i.e. the presence of a restriction on the transfer of the liability or the equity instrument) does not imply a price adjustment.

When quoted market prices are not available, not even for identical items held by another party as an asset, reporting entities should determine the fair value of liabilities and equity instruments by referring to other observable inputs, such as quoted prices in not active markets for identical items held by other parties as an asset. If observable prices in both active and not active markets are not observable, IFRS 13 allows the application of a valuation technique<sup>10</sup> from the perspective of a market participant that holds the liability or the equity instrument as an asset at the measurement date. Such valuation techniques might encompass:

- an *income approach*, considering future cash flows that a market participant would expect to receive from holding the liability or the equity instruments as an asset; or
- a *market approach*, based on quoted prices of similar liabilities or equity instruments held by other parties as an asset.

The adoption of an income approach, therefore, requires the reporting entity to consider the future cash outflows expected by the market participant

<sup>10</sup> On the topic of valuation technique in determining fair values, refer to paragraph 1.2. of the present chapter.