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Project	Fair Value Measurement		
Paper topic	Unit of account		
CONTACT(S)	Mariela Isern	misern@ifrs.org	+44 (0)20 7246 6483

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Purpose of this paper

1. This paper follows up the discussions held by the IASB in its February Board meeting. The purpose of the February meeting was to address questions received about the unit of account for financial assets that are investments in subsidiaries, joint ventures and associates measured at fair value. In particular, the IASB has received a question on whether the fair value of such investments should reflect the measurement of the investment as a whole or of the individual financial instruments included within that investment.[1] The purpose of this paper is to provide analysis for the IASB to decide how the questions raised should be addressed.

Summary

2. This section summarises our analysis and conclusions, highlighting the specific paragraphs in the paper where the detailed explanations can be found.

[1] Appendices 1 and 2 of this Agenda paper include third party correspondence that raises questions about the unit of account for particular items measured at fair value.

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3. The staff believe that the unit of account for investments in subsidiaries, joint ventures and associates is the investment as a whole (see paragraphs 10–20). We also believe that when considering the measurements of those investments, even though IFRS 13 *Fair Value Measurement* states that the unit of account is determined by the IFRSs that require or permit the fair value measurements, IFRS 13 implicitly states that the unit of account for the investments that are the subject of this paper is the investment as a whole (see paragraph 69 of IFRS 13 reproduced in paragraph 43 of this paper). However, the analysis provided in this paper also considers the effect that the two possible answers can have on the fair value measurement of the investments (ie the investment as a whole or the individual financial instruments).

4. During the February Board meeting the IASB also directed the staff to analyse the effects that different profiles of investors (ie financial or strategic investors) might have on the fair value measurements of those investments (see paragraphs 29-40).[2] This paper provides examples in which the investors are financial investors (paragraphs 33–37) and strategic investors (paragraphs 38–40) and have investments that will result in Level 2 or Level 3 fair value measurements. The main conclusions in both cases are that:

    (a) measurements based on the unit of account being the investment as a whole would provide a better depiction of the underlying economics of the entity's investment; and

    (b) an entity should consider all relevant facts and circumstances when measuring the fair value of those investments.

5. Regardless of the conclusion on the unit of account, our conclusion is that IFRS 13 generally provides sufficient guidance to perform Level 2 or Level 3 fair value measurements (see paragraphs 24–41).

6. We think that IFRS 13 is, however, less clear when Level 1 inputs are available for the underlying financial instruments that make up the investment (see paragraphs 42–50). Our preliminary assessment is that the population of

[2] The terms *financial* and *strategic investors* are described in paragraphs 30 and 31 of this Agenda paper.

investments that could potentially be affected by this lack of clarity in the requirements is, however, narrow.

7. For these particular measurements, we believe that the IASB has two options (see paragraphs 45–50):

   (a) Option 1 would result in measurements that would use adjusted Level 1 inputs (or that would use a valuation technique); and

   (b) Option 2 would result in measurements that would use unadjusted Level 1 inputs (ie the measurement would be the product of the quoted price (P) multiplied by the quantity (Q) of financial instruments held (ie PxQ)).

8. This paper also discusses the implications of these two options for impairment testing in paragraphs 51–56.

9. We believe that both options have pros and cons and that the final decision will depend on the weight that the IASB puts on each of those aspects.

Some considerations on the unit of account

10. This section highlights some considerations that the staff think are relevant in the discussion about the unit of account for investments in subsidiaries, joint ventures and associates. Before doing so we think it is worth recalling why the question on the unit of account has been raised.

11. The measurement requirements for investments in subsidiaries, joint ventures and associates in accordance with IFRS 10 *Consolidated Financial Statements,* IAS 28 *Investments in Associates and Joint Ventures* and IAS 27 *Separate Financial Statements* refer to IFRS 9 *Financial Instruments.* For most financial instruments, the unit of account is clear and, as a result, 'what is being measured' is clear (ie a contract that gives rise to an individual financial asset or an individual financial liability).[3]

[3] IAS 32 *Financial Instruments: Presentation* defines a *financial instrument* as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity".

12. The question that has been raised is whether those references to IFRS 9 should be understood to refer only to the measurement basis of the investments (ie fair value through profit or loss) or whether they should also be understood to prescribe the unit of account of those investments (ie the individual financial instruments that make up the investment).

13. The first step when measuring fair value is to determine **what** is being measured. The determination of 'what' takes into account the asset or liability that another Standard specifies can or must be measured at fair value. The question of 'what is that asset or liability' must be answered before its fair value can be measured. IFRS 13 defines *unit of account* as:

    > The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.

14. In addition, IFRS 13 states that "the unit of account for the asset or liability shall be determined in accordance with the IFRS that requires or permits the fair value measurement" (IFRS 13.14). In other words, **the fact that an asset is measured at fair value should not affect its unit of account**. Instead**, the unit of account determines what is measured**. This may affect the measurement. That is why, as noted above, IFRS 13 relies on the Standards that require or permit the fair value measurement to determine the unit of account.

15. In the case of financial assets that are investments in subsidiaries, joint ventures and associates, the staff believe that the unit of account is the investment as a whole instead of the individual financial instruments that make up the investment (see Agenda Paper 5 presented at the February Board meeting).[4] The staff note that when following the definition of *unit of account* above, the 'investment' is indeed the level at which the individual financial instruments are aggregated in IFRS 10, IAS 28 or IAS 27 for recognition purposes.

16. However, we note that some might think that, for example, having control of an investee is entity-specific. In their view, in the example of control, a parent **chose** to obtain a controlling interest investment (and could just as easily **choose** to exit

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[4] Agenda Paper 5, which was discussed by the IASB at its February 2013 meeting can be found at http://www.ifrs.org/Meetings/Pages/IASBFebruary2013.aspx.

its interest by selling multiple non-controlling interests). They think that an entity's choice to enter into a transaction in a particular way is not relevant in measuring fair value, which is a market based measurement. Consequently, they believe that the level of control or influence is not a relevant factor in determining whether the unit of account is the investment. The staff do not share this view. The IASB has concluded that the information needed about an investment in a 'controlling' interest is different from that needed about investments without control or other influence. As a result, different accounting and disclosures are specified for each of those situations. The staff also note that when the IASB was developing IFRS 13, it did not intend to change the unit of account prescribed by other Standards.

17. However, even though IFRS 13 is not the Standard that determines the unit of account of the assets and liabilities measured at fair value, it seems to acknowledge through its examples that the unit of account for the measurements that are the subject of this paper is the investment as a whole. The following excerpt from paragraph 69 of IFRS 13 illustrates this point:

> 69 […] Premiums or discounts that reflect size as a characteristic of the entity's holding […] rather than as a characteristic of the asset or liability (eg a **control premium** when measuring the fair value of **a controlling interest)** are not permitted in a fair value measurement.

18. If the IASB concludes the unit of account is the investment as a whole, the staff recommends amending IAS 27, IAS 28 and IFRS 10 to clarify that the investment is measured at fair value, with gains or losses to be recognised in profit or loss in accordance with IFRS 9. If the IASB concludes that the unit of account is the individual shares, we believe that references to 'control premium' and 'controlling interest' in paragraph 69 of IFRS 13 are confusing and might require amendment. The question to the IASB addressing this matter is in paragraph 57 of this paper.

The term 'investment' in this paper

19. The means by which an investor has control or joint control of, or significant influence over, another entity might not be restricted to the investor holding an equity investment. Those means might also include debt instruments or other

contractual arrangements. For example, paragraph 38 of IAS 28 states that **[emphasis added]**:

> '[…] The interest in an associate or a joint venture is the **carrying amount of the investment** in the associate or joint venture […] together with **any long-term interests** that, in substance, from part of **the entity's net investment** in the associate or joint venture. […]'.

20. However, the analysis performed in this paper will focus on equity investments held by an investor in subsidiaries, joint ventures or associates and, unless specified differently, whenever the term 'investment' appears in this paper it should be understood as being an equity investment. In other words, the analysis performed in this paper will focus on the interaction between the unit of account of an equity investment (ie the equity investment as a whole or the individual equity instruments that make up the investment) and its fair value measurement.

Staff's analysis of the interaction between the unit of account and fair value measurement

21. The staff's analysis of the interaction between the unit of account and fair value measurement in this section addresses the implications of the conclusion on the unit of account (ie the investment as a whole or the individual financial instrument(s)) for the resulting measurements.

22. The analysis of this interaction is based on whether the fair value measurement results in:

    (a) a Level 2 or Level 3 fair value measurement (see paragraphs 24–41); or

    (b) a Level 1 fair value measurement (see paragraphs 42–56).

23. For both resulting fair value measurements (ie Level 2 or Level 3 and Level 1) the staff has additionally analysed the effects that different profiles of investors (ie financial or strategic investors) might have on the fair value measurements of those investments.

Fair value measurements categorised within Level 2 or Level 3

24. Paragraph 69 of IFRS 13 states that an entity "shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability".[5]

25. Assuming that the asset that an entity is measuring at fair value is an 'investment', an entity would consider the characteristics of that investment (for example, the level of control or influence, when appropriate—see paragraph 26) in the corresponding fair value measurements to ensure that the resulting measurement reflects those characteristics appropriately. In some cases, such characteristics are included in the fair value measurements in the form of adjustments (for example, premiums or discounts), but not always.[6]

26. The staff believe that the following considerations on the existence of control premiums and their quantifications are relevant when performing those measurements:

    (a) An entity should assess whether it has evidence to conclude that a control premium associated with its controlling interest exists.

    (b) The quantification of control premiums should be based on the cash flow enhancements and/or on the reduced risks that holding a controlling interest might represent for a controlling shareholder. Control premiums are often associated with a controlling investor being able to take advantage of synergies and other benefits that flow from having control. However, when measuring a controlling interest at fair value, an entity would need to consider whether the reasons justifying a potential control premium are entity-specific or whether they could also be considered when undertaking a market-based measurement (ie whether market participants would consider them when pricing the controlling interest).

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[5] Consideration of the characteristics of the asset or liability in fair value measurement is also addressed in paragraphs 11–12 of IFRS 13. Paragraph 69 of IFRS 13 has been reproduced in paragraph 43 of this Agenda paper.

[6] Some valuation techniques would already reflect, for example, the value of control associated with a controlling interest. As a result, it would not be appropriate in those cases to apply a separate control premium adjustment.

(c) Traditionally control premiums have been assessed by an entity extracting observed control premiums from closed transactions in databases, but exclusive reliance upon those sources should be considered with caution, because those ‘control premiums’ might be due to other unrelated matters or simply might not be justifiable for the specific facts and circumstances surrounding the controlling interest being measured.

(d) When the underlying shares of the investments are quoted, that price does not necessarily mean that something more would be paid to obtain control of the entity. The fact that the entity is still publicly traded might provide evidence that there is no potential market participant buyer that believes that there is value above that quoted market price. In the case of a quoted entity, if no improvement of cash flows or risk reductions can be expected from an acquisition, a potential market participant buyer would probably not pay a price higher than the market quoted price. In that case, the control premium might be minimal or non-existent.

27. Note, of course, that consideration of the existence of any control premium would be relevant only if the conclusion on the unit of account is that the relevant item is the investment as a whole.

28. If the unit of account is concluded to be each of the individual financial instrument(s) that make up the investment, an entity would need to consider the characteristics of that asset (ie the individual financial instrument) in the fair value measurement. As a result, for example, the characteristic of the level of control or influence might, in many cases, not need to be included in the fair value measurements because it is improbable that a single financial instrument gives the investor the right to control or influence an investee. Consequently, some argue that a potential implication of the unit of account being the individual financial instruments is that a Day 1 loss might arise upon the acquisition of an investment for which a control premium was paid. Similarly (all other things being equal), a gain might arise upon the sale of that investment if a control premium is paid by the buyer.

Effects that different profiles of investors might have on the fair value measurements

29. This section further analyses how the differences between the likely profiles of the investors (including their reasons and goals for investing) might affect the fair value measurements of the investments. This is a subject that has been addressed in both academic and business literature.

30. This paper refers to investors holding investments within the scope of IFRS 10 and IAS 28 as *financial investors*.[7] As mentioned in paragraph 33, IFRS 10 requires investment entities to measure controlled investees at fair value and IAS 28 allows (or requires) fair value measurements for investors that are venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds or investment entities. Broadly speaking these entities are more likely to be financial investors. Financial investors commonly seek undervalued companies with a potential to improve their operations. After the acquisition, a financial investor treats the investee as a part of its financial portfolio and sells it when exit opportunities become sufficiently attractive. See paragraphs 33–37 and Examples 1 and 2.

31. In contrast, this paper refers to investors holding investments within the scope of IAS 27 as *strategic investors*. Strategic investors are usually companies in a related type of business (for example, a competitor, a customer or a supplier). They look for companies that offer long-term operational synergies and plan to integrate such companies into their own business.[8] See paragraphs 38–40 and Example 3.

32. According to the authors of the paper referred to in footnote 8, there are differences in how strategic and financial investors value companies:

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[7] We note that financial investors may also be required to prepare separate financial statements and, as a result, their investments might also be within the scope of IAS 27. In other words, the investments measured at fair value in accordance with IAS 27 might be hold by both financial and strategic investors. For the purposes of simplifying the analysis performed in this paper, we have aligned investments within the scope of IFRS 10 and IAS 28 to financial investors and we have aligned investments within the scope of IAS 27 to strategic investors.

[8] *Strategic and Financial Bidders in Takeover Auctions*, Alexander S. Gorbenko and Andrey Malenko, September 2010.

First, strategic and financial bidders value the target companies in systematically different ways. On average, strategic but not financial bidders are willing to pay higher premiums relative to market values for smaller targets that have substantial internal cash reserves and that undertake significant research and development activities. In contrast, financial bidders are willing to pay higher premiums for companies that underperform, which is reflected in substantial negative cash flows, but are insensitive to such target characteristics as size, q-ratio, and research and development expenses. Second, valuations of strategic and financial bidders react differently to changes in the economic environment. While valuations of strategic bidders seem to be unaffected by those, financial bidders appear to be willing to pay higher premiums (relative to the market values) for targets after a period of low market returns and when the costs of borrowing are lower. Perhaps the most striking evidence of difference between strategic and financial bidders, however, is in the sources of heterogeneity of their valuations. Valuations of financial bidders are to a large extent explained by observable factors, captured by the information about the targets available from the market and financial statements. In contrast, valuations of strategic bidders are less tied to publicly observable characteristics: their unobserved component of valuations is almost twice more important than that of financial bidders. This finding suggests a stark difference in heterogeneity of strategic and financial bidders. Financial bidders appear to be similar to each other and rather exchangeable from the target's point of view: they generate similar value in an auction based on objective characteristics. Each strategic bidder, however, is unique and can potentially generate substantial value. Valuations of strategic bidders are typically higher than those of financial bidders. An average strategic bidder is willing to pay a premium of 16.7% to the market value of the target, while the same number for an average financial bidder is 11.7%. However, the relation between valuations changes substantially with the characteristics of the target and the economic environment. In particular, perhaps contrary to common belief that strategic bidders always value targets more because only they can create synergies, we find a subset of mature underperforming targets that are on average valued more by financial bidders. For such targets, it is financial bidders that seem to generate higher synergies because of their ability to completely overhaul the target firm's operations.

Investments measured at fair value within the scope of IFRS 10 and IAS 28

33. The population of investments measured at fair value in IFRS 10 and IAS 28 are as follows:

    (a) investments in subsidiaries held by a parent that is an investment entity;

    (b) investments in joint ventures or associates held by an investor that is an investment entity; and

    (c) investments in joint ventures or associates held by an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds but that does not fulfil the definition of investment entity. For these entities, measuring those

investments at fair value is a measurement **option**, unlike (a) and (b) above which are **required** to be measured at fair value.

34. On the basis of views received from the Investment Entities project team and various stakeholders in the private equity industry, we understand that, in the majority of cases, the measurements of the investments included in paragraph 33 will result in Level 2 or Level 3 fair value measurements. This is because the vast majority of those investments will be in private companies. For example, in the case of the private equity industry, the majority of private equity initial investments will be in subsidiaries or associates that are private companies.[9] There are some exceptions. One of the ways of exiting those investments is through an initial public offering (IPO), and in an IPO the current shareholders might be restricted from selling part of their holding for some time. In those cases, a financial investor might have an interest in a listed investment. However, those investments are expected to be held for one to two years before exit occurs and are expected to be either investments in associates or holdings within the scope of IFRS 9. As a result, our initial assessment is that the population of investments that might result in Level 1 fair value measurements is narrow.

35. The following are the matters that we have considered to be relevant when measuring the fair value of investments in subsidiaries, joint ventures and associates held by financial investors:

    (a) Financial investors may pay a premium to acquire an investee. This premium relates to the efficiency opportunities that the financial investors foresee from the investee (for example, the financial investors might consider that there are opportunities to generate enhanced cash flows or that there is an opportunity to optimise the investee's capital structure).

    (b) In the case of an acquisition premium, this premium is commonly paid proportionately by all the shareholders in the investee who acquire the investee collectively. Also the contractual terms agreed in the

[9] We have learnt that there have been a few public companies that have been taken private, which could also mean that the companies held may still be listed for some time, but only for a short period (ie a period of months rather than years).

shareholders' agreements commonly ensure that controlling shareholders do not benefit from their controlling position by obtaining disproportionate returns. In other words, the controlling and non-controlling shareholders, typically, have access to the returns generated by the investee on a proportionate basis.

(c) Because the non-controlling shareholders would also benefit from the efficiency opportunities, it would be appropriate to keep the acquisition premium when measuring the fair value of the investment held by a non-controlling investor.[10]

(d) In some cases, a controlling financial investor might have the right to lead the exit process. This right is also known as a *drag-along right*.[11] This right could potentially result in a situation in which the ability to control provides a return that is disproportionate to ownership.

(e) In some cases, a non-controlling financial investor might have *tag-along rights*. These rights might allow the non-controlling financial investor to effectively limit the sale of shares held by the controlling financial investor or other key members of management by allowing it the right to purchase such shares from the controlling financial investor at the price offered by a third party and requiring that the controlling financial investor allows the non-controlling financial investor to substitute its shares for shares to be sold by the controlling financial investor.[12] The existence of those rights by the non-controlling financial investor contributes to diminish any

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[10] Chapter 7-Control and Marketability, Working Draft of the AICPA Accounting and Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, August 2012. This working draft can be found http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/DownloadableDocuments/Working_Drafts/Valuation_Equity/WD_Valuation_Equity_Securities.pdf

[11] The Working Draft of the AICPA Accounting and Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, August 2012, defines *drag-along rights* as rights that 'allow a majority of one class of shareholders to compel the holders of one or more other classes of shares to vote their shares as directed in matters relating to the sale of the enterprise.'

[12] Chapter 7-Control and Marketability, Working Draft of the AICPA Accounting and Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, August 2012.

premium that the controlling financial investor could obtain from leading the exit process.

36. The following example aims to illustrate how the matters above would affect the fair value measurement of the investments held by financial investors. This example additionally analyses whether the conclusion on the unit of account would have an impact on the fair value measurement of the investment.

Example 1—Measuring the fair value of an unquoted controlling interest and an unquoted interest in an associate held by financial investors

Investment Entity A (IE A) and Investment Entity B (IE B) have 80 per cent and 20 per cent interest respectively in Entity C, a private company. The equity capital structure of Entity C consists of 1,000 ordinary shares.

Before its acquisition by IE A and IE B, Entity C was a listed company. The acquisition of Entity C was eventually carried out at a price that included a premium of 11.7 per cent to Entity C's quoted closing market price at the acquisition date. The higher premium paid relative to the market is explained by the fact that Entity C had a poor cash flow-generating track record and, as a result, it had the potential to improve the efficiency of its operations. On the date of acquisition, the quoted closing market price of Entity C's shares was CU10[13] per share. As a result, the price paid by IE A and IE B for Entity C was CU11.17 per share.

The contractual terms included in the shareholders' agreements ensure that the controlling investor (ie IE A) does not extract value from its controlling position. Consequently, the minority shareholder (ie IE B) profits from the returns on the same proportionate basis in all phases of the investment (when entering into the investment, during the investment and on liquidation of the investment). The shareholders' agreement stipulates that IE A has the right to lead the exit process; however, IE B has *tag-along rights* that effectively limit the sale of the ordinary shares held by IE A, thereby allowing IE B to purchase shares from IE A at the price offered by a third

[13] In this paper, currency amounts are denominated in 'currency units' (CU).

party. This would mean that any discount for the lack of control when IE B measures the fair value of its investment would be minimal.

At the date of acquisition, Entity C's equity fair value is CU11,170. The price paid for Entity C already takes into consideration the relatively lower liquidity of its shares when compared to listed shares.

Based on the fact pattern above, the fair value of the controlling interest held by IE A and the fair value of the interest held by IE B (ie an interest in an associate) at the date of acquisition, are as follows:

	CU
Fair value of equity on acquisition	11,170.00
Fair value of controlling interest	**8,936.00**
Fair value of IE B's interest (ie associate)	**2,234.00**

Based on the specific fact pattern above, at initial recognition (at time t), the conclusion on the unit of account (ie whether it should be the investment as a whole or the individual shares) would not have affected the measurement.

At a subsequent period (at t+4), IE A assesses that a potential market participant buyer would be willing to pay a premium as a result of the performance enhancements achieved and based on the possibilities of locking in synergies with its own operations. When measuring its controlling interest subsequently, IE A follows the following steps.

	CU
Estimate the fair value of Entity C's equity IE A can do this by applying different valuation techniques. Assume that the equity value has been obtained by applying trading multiples (P/E) from comparable company peers.	XXXX
Discount for the lack of liquidity of its unquoted controlling interest in Entity C	(XX)

Any other adjustments that might be appropriate	-
Fair value of the unquoted controlling interest in Entity C	XXX

We believe that the conclusion on the unit of account could potentially have an effect on subsequent measurements of the investments. For example, in the case of the discount for the lack of liquidity, this discount could potentially be higher if the unit of account is the individual shares than if the unit of account is, for example, the unquoted controlling interest. This is because it is unusual for single shares in private companies to be bought or sold in stand-alone transactions. As a result, on a per share basis, the discount for the lack of liquidity could be higher when the unit of account is the individual shares than it would be when the unit of account is considered to be, for example, the unquoted controlling interest.

Instead of prescribing how the measurement should be decided upon, we believe that financial investors would need to consider all relevant contractual terms included in their shareholders' agreements and all facts and circumstances that are relevant in the measurement. As a result of this, even though it might be possible that the enterprise value used in valuing the controlling and non-controlling financial investors is the same:

(a) the value of the shares themselves might differ when different rights associated to the shares held by different types of investors receive appropriate consideration; and,

(b) the consideration of other facts not necessarily related to the contractual terms of the agreements, such as the discount for the lack of liquidity mentioned above, might result in different per share measurements when considering the unit of account to be the individual shares or, for example, the unquoted controlling interest.[14]

[14] Chapter 7-Control and Marketability, Working Draft of the AICPA Accounting and Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, August 2012.

37. The following example highlights the main considerations a controlling financial investor would consider when measuring its unquoted investment when the investee also has shares that are free floating.

Example 2—Measuring the fair value of an unquoted controlling interest held by a financial investor

Entity D has 20 per cent of its shares free floating. The remaining 80 per cent of its shares are unquoted and are held by Investment Entity F (IE F). IE F is required to measure the fair value of its controlling interest as at 31 December 20X5 (ie the measurement date).

When measuring the fair value of its controlling interest, IE F might consider whether (the list is not exhaustive):

(a) the free floating shares convey to their holders rights that are identical to those on the unquoted shares. In other words, IE F would need to consider whether the quoted and unquoted instruments are identical. This would be, for example, relevant if Entity D had two tiers of shares, in which the non-voting shares were the quoted ones and the voting shares were the ones privately held by IE F.

(b) the quoted price for the free floating reflects fair value (ie transactions observed are orderly transactions). If there has been a significant decrease in the volume or level of activity for the share in relation to normal market activity the quoted prices observed might not represent fair value.

(c) the exit price of its controlling interest should consider the value that might be realised upon the sale of the holding, in particular, if the probability that, for example, a strategic buyer would be willing to pay a premium as a result of obtaining synergies from controlling Entity D.

(d) it would be appropriate to apply a discount for the lack of liquidity of its unquoted controlling interest.

The staff believe the quoted price can be a good starting point to measure the fair value of the unquoted controlling interest above. However, we do not think that it would be appropriate that a controlling financial investor, such as IE F in this example, automatically assumed that the fair value of its controlling interest is the

result of multiplying the quoted price of the shares that are free floating by the number of shares it holds without appropriate consideration of the matters (a)–(d) above.

Investments measured at fair value in the scope of IAS 27

38. The population of investments measured at fair value in accordance with IAS 27 are as follows:

(a) investments in subsidiaries, joint ventures and associates held by a parent or an investor with joint control of, or significant influence over, an investee when that parent or investor are strategic investors. For these investors, measuring those investments at fair value is a measurement **option**; and

(b) investments in subsidiaries, joint ventures or associates held by financial investors (see paragraph 33 above).

39. This section analyses the case of investments included within paragraph 38(a). Assessing how commonly the measurements of those investments would result in a Level 1 fair value measurement rather than in Level 2 or Level 3 is more challenging in this case. However we believe that the following assumption is reasonable. For investments that are unquoted and that are held by strategic investors, because the latter have the option of measuring them at cost in accordance with IAS 27, we believe that the fair value measurement option will be less frequently used. For investments that are quoted and that are held by strategic investors, the fair value option might probably be more frequently used than the cost option because the entities would have a Level 1 input available for the underlying instruments.

40. The considerations on the existence of control premiums and their quantifications in paragraph 26 are relevant when performing those measurements. The example below illustrates the measurement of an unquoted controlling interest held by a strategic investor.

Example 3—Measuring the fair value of an unquoted controlling interest held by a strategic investor

A strategic investor has an 80 per cent controlling equity interest in Entity G, a private company. The equity capital structure of Entity G consists of 1,000 ordinary shares. The strategic investor measures its controlling interest at fair value for the period ending 31 December 20X5 (ie the measurement date).

After having considered different valuation techniques and the ranges of values indicated by them, the strategic investor has concluded that the fair value of its 80 per cent interest in Entity G's equity is CU860 at the measurement date.

The strategic investor further assesses that it has access to disproportionate returns compared with non-controlling shareholders and quantifies that there is a non-controlling interest discount of CU130 (see (a) below). In addition, the strategic investor believes that the fair value of its unquoted controlling interest should also consider the lack of liquidity of the shares held in Entity G.

- If the strategic investor measures its 80 per cent unquoted controlling interest, taking as the unit of account the investment, the resulting fair value per share would be:

	CU	
Fair value of equity (before adjustments)	860.00	
Non-controlling interest discount	-	(a)
Discount for the lack of liquidity	(86.00)	(b)
Fair value of controlling interest (investment) = [A]	**774.00**	
Fair value per share = [A] / 800 shares	**0.97**	

- If the strategic investor measures its 80 per cent unquoted controlling interest, taking as the unit of account the individual shares, the resulting fair value per share would be:

	CU	
Fair value of equity (before adjustments)	860.00	
Non-controlling interest discount	(130)	(a)
Unadjusted fair value = [B]	**730.00**	
Unadjusted fair value per share = [B] / 800 shares = [C]	**0.91**	
Discount for the lack of liquidity per share = [D]	**(0.30)**	(b)
Fair value per share = [C] - [D]	**0.61**	

(a): This assumes that the strategic investor has identified that there is a potential discount for not owning a controlling interest based on the cash flow enhancements and/or on the reduced risks that it obtains from its controlling position.

(b): This discount represents the strategic investor relative inability to convert its interest in the investee into a predictable amount of cash quickly and at a reasonably low cost as compared to controlling interests of comparable company peers that are publicly traded. In the case of controlling interests in unquoted entities, the discount for the lack of liquidity when considering the unit of account as being the investment as a whole could potentially be lower than when considering the unit of account as being the individual shares, because market participants rarely buy or sell single shares in a private company in stand-alone transactions.

We discussed the above measurements with a few users. They told us that the per share fair value measurement obtained when considering the unit of account to be the individual shares does not provide them with useful information.

41. Regardless of the conclusion that the IASB reaches on the unit of account, the staff think that the measurement guidance in IFRS 13 to perform Level 2 or Level 3 fair value measurements is clear enough to perform an appropriate fair value measurement with the following exception. As mentioned in paragraph 18, if the IASB concludes that the unit of account is the individual financial instruments, we believe that references to 'control premium' and 'controlling interest' in paragraph 69 of IFRS 13 are confusing and might require amendment.

Level 1 fair value measurements

42. In the case of quoted investments in subsidiaries, joint ventures and associates, there is a Level 1 input for the underlying instruments that make up the investment. In February we discussed with the IASB that depending on what is considered more important (ie the unit of account or the requirement in IFRS 13 to prioritise Level 1 inputs), this leads to the following views:

    (a) Proponents of **View 1** believe that because Level 1 inputs are defined as quoted prices for identical assets, there is no Level 1 price for the investment as a whole. Instead, the Level 1 price is for the underlying financial instruments, which are not 'the asset' being measured at fair value. Consequently, that Level 1 input cannot be the sole determinant of the fair value of the investment and the investment's fair value must either be measured using another valuation technique or by adjusting the Level 1 input to reflect differences between the investment and the underlying individual financial instruments. Proponents of this view would prioritise the unit of account of the asset or liability that is measured at fair value above the availability of Level 1 inputs.[15]

    (b) Proponents of **View 2** believe that because the investment comprises individual financial instruments that have a Level 1 price, that Level 1 input must be used and the fair value measurement of those investments would be the product of the quoted price multiplied by the quantity held (PxQ) without adjustments. Proponents of this view would prioritise the availability of Level 1 inputs above the unit of account (ie Level 1 inputs always provide the most reliable evidence of fair value).[16]

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[15] Proponents of this view could also use the requirements in paragraph 69 of IFRS 13 reproduced in paragraph 43 to reach this interpretation.

[16] Proponents of this view could use the requirements in paragraph 80 of IFRS 13 reproduced in paragraph 43 to reach this interpretation.

43. The staff believe that this divergence in views result from paragraphs 69 and 80 of IFRS 13 not being clear. Paragraphs 69 and 80 are reproduced below **[emphasis added]**.

> 69 An entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability […]. In some cases those **characteristics result in the application of an adjustment**, such as a premium or discount **(eg a control premium or non-controlling interest discount)**. However, **a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the IFRS that requires or permits the fair value measurement […]**. Premiums or discounts that reflect size as a characteristic of the entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 80) **rather than as a characteristic of the asset or liability (eg a control premium when measuring the fair value of a controlling interest)** are not permitted in a fair value measurement. In all cases, **if there is a quoted price in an active market (ie a Level 1 input) for an asset or a liability, an entity shall use that price without adjustment when measuring fair value**, except as specified in paragraph 79.

> 80 If an entity holds **a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments) and the asset or liability is traded in an active market, the fair value of the asset or liability shall be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity.** That is the case even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

44. Does 'an asset' in the last sentence of paragraph 69 also refer to a 'controlling interest'? If so, the answer is that there are no Level 1 inputs for such an asset. Should one interpret that 'a holding of financial instruments', in the first sentence of paragraph 80, also includes a 'controlling interest'? Is so, the answer is that the measurement of such controlling interest should then be obtained by multiplying the quoted price by the number of instruments held (ie PxQ).

45. As mentioned in paragraph 43, the staff think that the Standard is not clear about the interaction between the unit of account and the use of Level 1 inputs. As a result, IFRS 13 is open to different interpretations on this point and the staff believe it should be clarified. As mentioned in the February meeting, the staff think there are two options for the IASB to consider:

    (a) Option 1: require an entity to measure the fair value of an investment in accordance with that unit of account (ie as the investment as a whole),

regardless of whether there is a Level 1 input for the underlying financial instruments within that investment.

(b) Option 2: even if the unit of account is the investment as a whole, if a Level 1 input exists for the individual financial instruments that make up the investment, require an entity to measure the fair value of the investment as the product of the Level 1 input (without adjustment) multiplied by the quantity held (PxQ).

46. The staff think that if the IASB chooses to require Option 1, it could also require an entity to disclose the product of the quoted price multiplied by the quantity held (PxQ). Doing so would provide users of the entity's financial statements with the information that would result from Option 2.

47. The staff note that if the IASB were to conclude that Option 1 is the most appropriate option, the differences between the profiles of the financial and strategic investors and any other relevant facts and circumstances would be embedded in the measurements in a similar manner to that discussed for Level 2 or Level 3 fair value measurements (see Examples 1–3). If the IASB were to conclude that Option 2 is the most appropriate option, the measurement of those investments will be the result of using unadjusted Level 1 inputs and, consequently, there will be no consideration of any other matters that an entity would have contemplated when performing a valuation exercise.

48. The following table summarises the issues for the IASB to consider in choosing whether to require Option 1 or Option 2.

Issue	Option 1	Option 2	Staff's assessment of the issue
Consistency between the unit of account and the resulting fair value measurement	Respects the unit of account of the asset (ie the investment) being measured at fair value.	If there is a Level 1 input, this is prioritised without consideration of the unit of account.	Option 1 is superior.
Maximising the use of observable inputs	The measurement would contain inputs that are not observable (for example, adjustments for premiums and discounts that are not observable) resulting in a less objective fair value measurement, and downgrading it to a lower level within the fair value hierarchy. It might have far-reaching consequences. For instance, it opens up the possibility of entities in other situations making analogies and consequently inappropriately adjusting Level 1 inputs or not using them at all.	It respects the principle of maximising the use of relevant observable inputs (see paragraph 61 of IFRS 13). Would result in a Level 1 fair value measurement. Level 1 inputs provide the most reliable evidence of fair value.	Option 2 is superior.

Issue	Option 1	Option 2	Staff's assessment of the issue
Consistency in the methodology used for measuring fair value	The measurement methodology would be consistent whether the investment is quoted or unquoted. The fair value measurement would reflect the characteristics of the asset (control, joint control, significant influence) regardless of whether the individual underlying financial instruments are quoted or unquoted. The fact that the underlying financial instrument is quoted or not would be reflected through other characteristics, such as liquidity.	The measurement methodology would differ depending on whether the investment is quoted or unquoted. See comments on this issue for Option 1. This option might be challenging to apply when, for example, an investment in a subsidiary has both quoted and unquoted shares.	Option 1 is superior.
Measurements with economic content	Results in a more economically sound measurement, because it considers the characteristics of the asset (control, joint control, significant influence) that market participants would take into account when pricing the asset.	Level 1 fair value measurements without adjustments might not necessarily result in economically superior measurements to the extent that the Level 1 price reflects the fair value of the underlying financial instruments but not of the	Option 1 is superior.

Issue	Option 1	Option 2	Staff's assessment of the issue
		investment as a whole.	
Day 1 gains and losses	Reduces the possibility of a Day 1 loss arising from paying a premium to acquire an investment that results in control, joint control or significant influence. Similarly, reduces the possibility of a gain upon the sale of such an interest if the buyer pays a premium for control, joint control or significant influence.	A Day 1 loss might arise if a premium was paid to acquire an investment that results in control, joint control or significant influence. Similarly, upon sale there could be a gain if the buyer pays a premium for control, joint control or significant influence.	Option 1 is superior.
Convergence	US GAAP requires PxQ if Level 1 exists for the individual financial instruments.	US GAAP requires PxQ if Level 1 exists for the individual financial instruments.	Option 2 is superior.
Usefulness of the information provided by the resulting measurements	The focus of the Fair Value Measurement project was on 'how' to measure fair value and not on 'what' was to be measured at fair value. The measurements resulting from Option 1 and Option 2 are dependent on whether the IASB believes that the relevant unit of account is the investment as a whole in all cases (ie regardless of the existence of underlying individual financial instruments with Level 1 prices). Because this issue was outside the scope of the Fair Value Measurement project, no outreach was undertaken to conclude on which resulting measurement would provide users more useful		

Issue	Option 1	Option 2	Staff's assessment of the issue
	information (ie the measurement of the investment or the measurement of the underlying individual financial instruments, and their views on whether to prioritise Level 1 inputs in the former case). The staff believe that it is important to understand which measurement provides better information for users of financial statements. The staff think that this input can be obtained through outreach carried out during the comment period of any proposed amendments that the IASB deems necessary to address the issues that are the subject of this paper. The staff have recently reached out a few users and they have informed us that they would prefer a PxQ measurement (Option 2) complemented with sufficient disclosures so that, if needed, they could compute any adjustments to that measurement separately.		

49. If the IASB concludes that the unit of account is the investment as a whole, the following summarises, for information purposes, the additional implications of Options 1 and 2 in terms of amendments to IFRS 13:

    (a) If the IASB chooses Option 1 the staff believe that the IASB might need to amend IFRS 13 to ensure that it is clear that an entity should prioritise the unit of account of the asset or liability over the existence of Level 1 inputs if those inputs are for a different unit of account. Option 1 might also trigger amendments to IFRS 12 *Disclosure of Interests in Other Entities* (see paragraph 46 above).

    (b) If the IASB choses Option 2 the staff believe that the IASB will need to clarify in IFRS 13 that, even though the unit of account is the investment as a whole, if that investment is made up of financial instruments for which there is a Level 1 input, those inputs should be used without adjustment when measuring the fair value of the investment.

50. As mentioned in paragraphs 18 and 41, if the IASB concludes that the unit of account is the individual financial instruments, we believe that references to 'control premium' and 'controlling interest' in paragraph 69 of IFRS 13 are confusing and might require amendment. This would result in using Level 1 inputs without adjustments (which would be consistent with measuring the fair value of financial instruments within the scope of IFRS 9 or IAS 39 *Financial Instruments: Measurement and Recognition*).

Implications for impairment testing

51. Views 1 and 2 in paragraph 42 above also have an impact on the measurement of the fair values of cash-generating units (CGUs) for impairment test purposes when an entity has, for example, quoted subsidiaries. Before analysing the different views, it is worth noting the definition of a CGU in IAS 36 *Impairment of Assets* **[emphasis added]**:

    > A cash-generating unit is the smallest identifiable **group of assets** that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

52. Under View 1, the fair value of a CGU with a Level 1 price would reflect the characteristics of the CGU as a whole (for example, its fair value would reflect the value of control if applicable) and would result in measurements for which Level 1 inputs have been adjusted or another valuation technique (for example, discounted cash flow method or current replacement cost) was used. Consideration of control premiums in the fair value measurements of quoted CGUs would be more closely aligned with 'value in use', because value in use reflects the value of control.[17] In addition, such a measurement would also be aligned with the US GAAP impairment literature, which allows Level 1 inputs to be adjusted for control premiums when measuring the fair value of a reporting unit for impairment testing.[18]

53. Under View 2, the fair value of a quoted CGU would be obtained by using unadjusted Level 1 inputs: ie, it would be the product of the Level 1 price multiplied by the quantity (for example, the number of shares) held. The fair values would be determined on a different basis than value in use. Furthermore, fair value for impairment testing purposes in IFRSs would not be aligned with fair value for impairment testing purposes in US GAAP.

54. The reason why US GAAP allows the use of adjusted Level 1 inputs to obtain the fair value amounts of reporting units for impairment testing purposes is because the US GAAP's impairment testing model does not have a 'value in use' concept. The rationale for why the FASB allowed adjustments to quoted prices for reporting units for impairment testing purposes is similar to the IASB's rationale for having a 'higher of' threshold for recognising impairment in IAS 36.

55. The staff also note that IAS 36 does not refer to IFRS 9 when referring to fair value less costs of disposal for impairment testing purposes. Consequently, the issues outlined in paragraph 12 regarding the potential conflict for the unit of account do not apply to this issue—the only question is the interaction with IFRS 13's requirement to prioritise the use of Level 1 inputs.

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[17] IAS 36 defines value in use as "the present value of the future cash flows expected to be derived from an asset or cash-generating unit".

[18] See ASC paragraphs 350-20-35-22 through 35-24.

56. The staff believe that, for impairment testing purposes, because the fair value measurement resulting from Option 1 reflects the unit of account (ie the CGU) and the CGU's other characteristics, Option 1 is superior to Option 2. Having said that, the staff note that because IAS 36 contains a 'higher of' threshold and permits the use of value in use (which reflects the unit of account and the CGU's other characteristics), there is less pressure on having to align fair value measurements to Option 1 for CGUs associated with quoted subsidiaries that have Level 1 prices.

Staff's recommendations on the unit of account and on the interaction between Level 1 inputs and unit of account

57. This section summarises our recommendations and conclusions:

   (a) The staff think that the unit of account for investments in subsidiaries, joint ventures and associates is the investment as a whole. This conclusion would imply amendments to the measurements requirements in IAS 27, IAS 28 and IFRS 10 to clarify that references to IFRS 9 should be understood to refer only to the measurement basis rather than to the unit of account.

   (b) The staff think that the guidance in IFRS 13 is generally clear to perform Level 2 or Level 3 fair value measurements with one exception. If the IASB concludes the unit of account is the individual financial instruments, references to 'control premium' and 'controlling interest' in paragraph 69 of IFRS 13 might require amendment.

   (c) For Level 1 measurements, the staff think that the requirements in IFRS 13 should be clarified. In addition, the staff believe that, in its discussions, the IASB should take into consideration:

      (i) that the population of investments that comprise listed financial instruments, according to our initial assessment, is expected to be narrow;

      (ii) from a conceptual point of view, the weight it places on the benefits of having more objective and transparent measurements (ie

unadjusted Level 1 measurements) compared with the costs of using inputs that do not correspond to the asset being measured;

(iii) from a practical point of view, the weight it places on the benefits of having a more economic measurement compared with the costs for preparers of carrying out a valuation exercise when Level 1 inputs are available and when, from the very limited outreach performed, users would prefer the measurements to be based on unadjusted Level 1 inputs (ie PxQ).

Questions for the IASB

Question 1 – Unit of account

Does the IASB agree with the staff's conclusion that the unit of account in the Standards dealing with the accounting for subsidiaries, joint ventures and associates should be the investment as whole?

Question 2 – Interaction between the unit of account and fair value measurement

On the basis of the staff's analysis, which of the options described above does the IASB consider to be the most appropriate for:

(a) measuring investments in subsidiaries, joint ventures or associates at fair value whose underlying individual financial instruments have a Level 1 price (paragraphs 42-50):

(i) Option 1 (unit of account is considered to be more important), or

(ii) Option 2 (prioritisation of Level 1 inputs is considered to be more important)?

(b) measuring fair value less costs of disposal for impairment testing purposes (paragraphs 51–56):

(i) Option 1 (unit of account is considered to be more important), or

(ii) Option 2 (prioritisation of Level 1 inputs is considered to be more important)?

AGENDA PAPER 4 – APPENDIX 1
18-22 MARCH 2013

IFRIC potential agenda item request

This letter describes two related issues that we believe should be added to the IFRIC's agenda. We have included a summary of the issues, a range of possible views and an assessment of the issues against the IFRIC's agenda criteria.

There is currently no established practice because IFRS 13 *Fair Value Measurement* is not yet in effect. However, we believe that these issues are likely to establish themselves as practice issues once entities begin to apply the standard. We believe that the IFRIC should consider the issues because the potential outcomes could have a significant effect on the measurement of fair value, and consistency in this area is desirable.

Issue 1: The unit of account for financial assets that are investments in a subsidiary, joint venture or associate and related retained or pre-existing interests

IFRS 13 explicitly introduces the concept of the 'unit of account', which is determined in accordance with the relevant IFRS that requires or permits the fair value measurement. In many cases the unit of account can be inferred, e.g. a cash-generating unit in IAS 36 *Impairment of Assets*; however, for a financial asset that is an investment in a subsidiary, joint venture or associate it is not clear because the investment held by the entity comprises a number of individual shares.

The following are examples:

1. An investment in a subsidiary, joint venture or associate accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* / IFRS 9 *Financial Instruments* in separate financial statements. [IAS 27.10(b)]
2. An investment in a joint venture or associate accounted for in accordance with IAS 39 / IFRS 9 by a venture capital or similar organisation. [IAS 28.18]
3. An investment in a subsidiary, joint venture or associate measured at fair value in accordance with IAS 39 / IFRS 9 by an investment entity. [Forthcoming amendment to IFRS 10 and IAS 28]
4. Shares in a subsidiary, joint venture or associate distributed to owners. [IFRC 17.11]
5. A previously held equity interest in an acquiree in accounting for a business combination achieved in stages. [IFRS 3.42]
6. A retained interest following a loss of control, joint control or significant influence. [IFRS 10.25(b), IAS 28.22(b)]

For all of the above items, the issue is whether the unit of account is an individual share or the entire holding. This interpretation makes a difference in applying IFRS 13. For example, if the unit of account is an individual share, then there is no possibility of arguing, for example, that a premium related to the size of the holding should be included in the measurement of fair value.

The following are the different approaches that we believe an entity could take once IFRS 13 becomes effective.

View 1: Unit of account is the entire investment

Notwithstanding that the investment comprises a number of individual shares, the unit of account is the investment as a whole. This is on the basis that the accounting in the underlying IFRS (or Interpretation) is premised on the item as a whole, and not on it being a collection of smaller items.

View 2: Unit of account is the individual share

For financial assets, even if outside the scope of IAS 39 / IFRS 9, the unit of account is the individual share, which is consistent with the approach generally taken under IAS 39 / IFRS 9. This is consistent with IFRS 13.BC47, which states that the unit of account under IAS 39 / IFRS 9 is generally an individual financial instrument.

View 3: Mixed approach depending on the financial asset

Views 1 and 2 represent the two extremes, but in between there are more nuanced approaches that seek to distinguish between the types of investments / references within the standards. The following are two examples of which we are aware:

- *Investments in subsidiaries, joint ventures and associates vs 'other items'*

  Under this approach, the unit of account for investments in subsidiaries, joint ventures and associates is the entire investment. While the investment comprises a number of individual shares and therefore it might be argued that the unit of account should be the same as if the general approach under IAS 39 / IFRS 9 is applied, the accounting models for such investments acknowledge that control, joint control and significant influence have a special significance and that the accounting relates to the investment (relationship) as a whole.

  However, investments that do not confer control, joint control or significant influence are no different from other financial assets within the scope of IAS 39 / IFRS 9, and therefore the unit of account should be the individual share.

- *Investments whose accounting is 'in accordance with' IAS 39 or IFRS 9 vs 'other items'*

  Under this approach, the unit of account for the investment is the individual share when the relevant IFRS specifically refers to accounting 'in accordance with' IAS 39 / IFRS 9, or when IAS 39 / IFRS 9 applies subsequently. This would apply to the first three examples raised at the start of this letter, plus the sixth example (loss of control) in many cases.

  In all other cases, the unit of account would be the entire investment.

Issue 2: Interaction between guidance on use of Level 1 inputs and the unit of account

Having established the unit of account, it is then necessary to determine the 'unit of valuation'. Although this term is not defined in IFRS, it is used in this letter to indicate the level at which an asset or a liability is aggregated or disaggregated for the purpose of measuring fair value.

As a general principle, the unit of valuation is based on the unit of account for the asset or liability determined in accordance with the IFRS that requires or permits the fair value measurement, subject to the exceptions in IFRS 13, e.g. in paragraph 48. However, the standard is unclear on the interaction between the unit of account/valuation guidance in paragraph 14 and the requirement to use unadjusted Level 1 prices, when available, in paragraphs 69, 77 and 80.

Possible approaches

The following are the different approaches that we believe an entity could take once IFRS 13 becomes effective.

View 1: Level 1 price required only if available for the unit of account

A Level 1 price is applied without adjustment only if it exists for the unit of valuation established under the relevant IFRS that requires or permits the fair value measurement or by another requirement in IFRS 13. If that unit of valuation is an aggregation of assets or liabilities and a Level 1 price is unavailable at that level, then it is not required that the Level 1 price for an individual asset or liability be used without adjustment to value the aggregate holding.

View 2: Level 1 price takes precedence as a matter of principle

Even if the unit of valuation would otherwise be an aggregate holding, the fair value of an aggregate position that comprises items that are quoted in an active market to which the entity has access at the measurement date must be measured as the product of the Level 1 price for the individual item and the quantity held by the entity.

View 3: Level 1 price takes precedence as a matter of reliability

The guidance on Level 1 inputs that is provided in IFRS 13.77 requires an entity to use, if available, a quoted price in an active market because it provides the most reliable evidence of fair value. Therefore, based on its observability, a Level 1 price for constituent assets and / or liabilities takes precedence over a Level 2 or Level 3 price for the unit of valuation.

Although Views 2 and 3 are different, they both result in a fair value measurement for an aggregated position based on the price of an individual constituent asset or liability times the number of assets or liabilities held.

Examples

The following examples illustrate the effect of the above views.

Cash-generating unit that corresponds to a listed entity

The unit of account for impairment testing under IAS 36 is not an individual share but the cash-generating unit (CGU) as a whole comprising its underlying operating assets and liabilities.

Under View 1, because a price is not available in an active market for the whole CGU, neither IFRS 13.69 nor 80 apply. Accordingly, if a market participant would include a premium for control in valuing the CGU, then the fair value of the CGU includes a control premium. Although the Level 1 price for an individual share would be a very important input in determining fair value, it would not necessarily be determinative in valuing the CGU as a whole.

The following are additional arguments in favour of this view for a CGU:

- IFRS 13.69 specifically discusses the application of a control premium to value a controlling interest. The ability to consider a control premium to measure the fair value of a holding in a CGU whose shares are not publicly traded, but not when a CGU’s shares are publicly traded, would result in the inconsistent treatment of similar interests.

- If an entity paid a premium to acquire control of a CGU but was subsequently required to measure the CGU using a share price that excluded a control premium, impairment could result, even if there had been no underlying decline in the economic value of the CGU.
- US GAAP allows the inclusion of a control premium when valuing a reporting unit for impairment testing, even when a Level 1 price for the underlying shares is available.[1]
- The carrying amount of a CGU is generally based on operating assets and liabilities and excludes items such as financing items. However, a share price will reflect all of the assets and liabilities of the legal entity that issued the shares, including non-operating assets and liabilities. Therefore, an issue is practice may be whether the market capitalisation based on the share price is a like-for-like comparison with the items included in the carrying amount of the CGU.

Under View 2, the unit of valuation differs from the unit of account through the application of IFRS 13.69 and 80, and is an individual share because a Level 1 price is available at that level. Therefore, no control premium would be considered in valuing the CGU, even if market participants would consider such a premium in valuing a controlling stake in the CGU; this is because a control premium does not attach to an individual share.

Under View 3, the unit of valuation is the CGU, consistent with the general principles in IFRS 13.13-14. However, the Level 1 price is seen as the most reliable measure of fair value to be used in all circumstances. Under this view, the fair value of the CGU would be determined as the Level 1 price times the quantity held as this will provide the most verifiable evidence of fair value.

The logic of the three views outlined above applies equally to other examples, such as the fair value of an investment in a subsidiary, joint venture or associate when the unit of account is the entire investment (see Issue 1).

Portfolio exception for financial assets and financial liabilities

The unit of account for financial assets and financial liabilities subject to the portfolio exception is the individual financial instrument in accordance with IAS 39 / IFRS 9.

Under View 1, the unit of valuation is the net risk exposure in accordance with IFRS 13.48. A Level 1 input for an individual financial instrument is not a Level 1 input for the net risk exposure; therefore, neither IFRS 13.69 nor 77 apply. Consequently, it is irrelevant whether there is a Level 1 input available for an individual financial instrument as the fair value measurement should be based on the characteristics of the net risk exposure. This leads to consistent application of the portfolio exception regardless of the categorisation of the constituent financial assets' or financial liabilities' fair value measurements in the fair value hierarchy. This is consistent with the fact that IFRS 13 does not restrict the portfolio exception only to portfolios that contain solely financial assets and financial liabilities that would be categorised within Levels 2 or 3.

Under Views 2 and 3, the portfolio exception cannot be applied to portfolios containing financial assets and financial liabilities for which a Level 1 price exists. The portfolio exception is designed for portfolios containing financial assets and financial liabilities that are categorised within Levels 2 or 3 of the fair value hierarchy. The restrictions on the adjustment of Level 1 inputs prohibit application of the portfolio exception to portfolios that contain financial assets and financial liabilities for which a Level 1 input exists. Application of the portfolio exception would lead in this case to measurements that are not in accordance with IFRS 13. For example,

[1] ASC paragraphs 350-20-35-22 through 35-24

any portfolio level adjustment based on a portfolio containing financial assets and financial liabilities for which a Level 1 price is available implies an adjustment of the quoted price for these individual assets and liabilities, regardless of the methodology for allocating the portfolio level adjustments. This would be inconsistent with IFRS 13.69, 77 and 80. Alternatively, allocation of the total portfolio level adjustment to only the individual financial assets and financial liabilities that are categorised in Level 2 or 3 leads to measurement of these financial assets and financial liabilities in a manner that is not representative of their respective exit prices.

Under an additional View 4 that is relevant in relation to the portfolio exception, the portfolio exception could be applied only if it maximises value. It is expected that entities that qualify for the portfolio measurement exception would choose to apply the portfolio exception because management of the net risk exposure maximises value to the entity. This is in line with IFRS 13.22, which explains that a fair value measurement is based on assumptions used by market participants, who act in their economic best interest. In addition, as stated in IFRS 13.BC67, a fair value measurement assumes that market participants seek to maximise the fair value of a financial asset or to minimise the fair value of a financial liability and such a transaction might involve grouping assets and liabilities in a way in which market participants would enter into a transaction, if the unit of account in other IFRSs does not prohibit that grouping. Accordingly, the portfolio exception may not be applied so as to change the unit of valuation in a manner that leads to less favourable fair value measurements than arise from valuing the individual financial instruments within the portfolio on a stand-alone basis. The guidance in IFRS 13.69, 77 and 80 generally requires the use of unadjusted Level 1 inputs for the individual constituent financial assets and financial liabilities for which Level 1 inputs are available. This guidance on Level 1 inputs precludes an application of the portfolio exception that results in less favourable fair value measurements than without its application.

For example assume the following fact pattern:

- Long position of 10,000 individual financial assets and short position of 9,500 individual financial liabilities in a particular market risk.
- Bid price is CU 98; mid price is CU 100; ask price is CU 102.
- The most representative exit price within the bid-ask spread of an individual financial asset is CU 99, and of an individual financial liability is CU 101.
- The most representative exit price for a net position of 500 financial assets is CU 45,000.
- All financial assets and financial liabilities are categorised in Level 1 of the fair value hierarchy.

Without application of the portfolio exception, the fair value measurements of the financial assets and financial liabilities would be based on their individual fair values. As such, a fair value measurement of the portfolio would be CU 30,500 (CU 10,000 × CU 99 - CU 9,500 × CU 101). In this example, a fair value measurement based on the net risk exposure amounting to CU 45,000 maximises value to the entity. Under View 4, the fair value measurement of the group of financial assets and financial liabilities is based on the fair value of the net risk exposure, although the fair value measurement cannot be lower than the fair value using the Level 1 inputs of the constituent financial assets and financial liabilities amounting to CU 30,500. Therefore, based on View 4, in this specific fact pattern an entity would be allowed to apply the portfolio exception to value the net risk exposure as a single item.

Reasons for the IFRIC to address the issue

a) ***Is the issue widespread and practical?*** Yes. The determination of fair value is integral to the application of IFRS.

b) ***Does the issue involve significantly divergent interpretations?*** Yes. Depending on the interpretation applied, the different approaches to the measurement of fair value (e.g. whether to include a control premium) could have a significant effect on an entity's financial position and financial performance.

c) ***Would financial reporting be improved through elimination of the diversity?*** Yes. The comparability of financial statements will be improved if entities determine fair value on the same basis.

d) ***Is the issue sufficiently narrow…?*** Yes. Regarding Issue 1, we believe that the issue is capable of interpretation within the confines of IFRS 13 to the extent that standards are already issued; in the future, the issue can be dealt with by the Board in the context of each new standard or amendment. Regarding Issue 2, we believe that the issue is capable of interpretation within the confines of IFRS 13. Both issues related to specific concepts introduced by IFRS 13.

e) ***If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*** The issue does not relate to a current or planned IASB project.

AGENDA PAPER 4 – APPENDIX 2
18-22 MARCH 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

21 December 2012

Dear Mr Hoogervorst

The purpose of this letter is to seek an interpretation from the IASB of how to determine the unit of account when measuring the fair value of investments in unquoted companies.

Background

This letter is submitted jointly by the British Venture Capital and Private Equity Association ("BVCA"), the European Venture Capital and Private Equity Association ("EVCA"), the International Private Equity and Venture Capital Valuation Board ("IPEV") and the Association Francaise des Investisseurs pour la Croissance ("AFIC").

The BVCA, AFIC and EVCA are the private equity and venture capital industry associations representing the UK, France and Europe respectively. IPEV was established in 2005 to prepare valuation guidelines for the industry, releasing updated guidelines on 17 December 2012 and whose previous 2010 guidelines were endorsed by 40 national associations.

This letter follows earlier discussions between representatives of BVCA and IPEV with Hilary Eastman and Sarah Geisman in October and November 2012 and a meeting BVCA had with you on 30 October 2012.

Issue

We believe that the accounting guidance within IFRS 13 and IFRS 9/IAS 39 on unit of account in the context of measuring the fair value of investments in unquoted companies is limited and ambiguous. We note that there is a range of views on how to interpret existing guidance and that a view with support from leading accounting firms is that the unit of account should be an individual financial instrument (a so called "single share" basis).

We believe that this conclusion is contrary to the "market participant" philosophy embedded within IFRS 13 and is inconsistent with how market participants transact. Our contention is that nobody would buy or sell a single share in a private company in a standalone transaction

and we do not believe market participants should be compelled by accounting standards to assume hypothetical transactions that never occur with market participants who do not exist.

The principal consequences of assuming the unit of account to be an individual instrument are considered in our detailed submission which is attached as an appendix to this letter.

We note that US GAAP allows the unit of account to be determined at the enterprise level and believe that a similar conclusion is necessary under IFRS if that framework is to remain relevant to the private equity industry. We note the progress made with regard to "Investment Entity" accounting rules and feel a favourable resolution of the unit of account issue ambiguity is necessary to allow that new accounting basis to be widely adopted.

Our request

We request that the IASB considers our submission and issues guidance which will allow market participants to interpret accounting standards in a way which is consistent with how they measure and evaluate their economic activity.

Please contact Iain Bannatyne representing BVCA at +44 (0) 20 7311 8664 or David Larsen representing IPEV at +1 415 693 5330 if you would like to discuss any of the issues in this letter.

Yours faithfully

Simon Witney

Chairman, BVCA Legal and Technical Committee

cc Hilary Eastman, Sarah Geisman

Appendix – submission to IASB on unit of account

Purpose of IPEV guidelines

The IPEV valuation guidelines represent a valuation framework which is not intended to be GAAP but guidelines aimed at producing a GAAP consistent result. These have been developed with input from preparers (General Partners), users (Limited Partners) and service providers (auditors/valuation experts), are long established as the best source of industry developed valuation guidance and are required by many investment entity fund formation agreements. Staff from IASB and FASB has also contributed to the drafting process.

The guidelines seek to provide a meaningful result for both experienced and new investors into the PE sector; they are designed to be understandable to non-accountants and seek to provide consistency in approach across the market.

The guidelines were recently updated to reflect IFRS 13 and that process has highlighted the difficulties in applying that standard in a private equity context.

Basis of existing PE market practice

A summary of how market participants currently measure the fair value of their investments is as follows:

- Fair value represents a hypothetical exchange price – the value of what you have today given the market conditions today.
- In other words, given individual facts and circumstances, how much would a market participant pay for the investment in a hypothetical orderly transaction at the measurement date?
- If market participant assumptions are not used and if facts and circumstances are not properly considered, there is a risk that the fair value of an investment would be measured at an amount which differs from the amount of cash or other consideration that would be received in an orderly exit transaction at the measurement date.
- Investors and users of fund financial statements must have fair value estimates of the underlying investments (generally articulated as NAV) to allow fund interests to be reported at fair value in their own financial statements.
- Most private equity backed businesses are unquoted and valuers have historically used the fair value of the enterprise on an aggregated basis as a starting point for the equity valuation.
- Deduction is then made for higher ranking instruments – typically debt. Change of control clauses are typical which means that in an exit transaction all debt is repaid.

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Therefore debt is deducted at "par" (for purposes of determining the fair value of equity) given the market participant assumption that the remaining term is zero on change of control.

- Valuing the equity investment in aggregate is market convention: it reflects how a market participant would view a transaction and is consistent with the way PE firms actually transact.
- Additionally, there are other situations where characteristics stemming from the size of the holding determine the accounting approach. For example where a holding company (which is not an investment entity) has a controlling stake in a business then that business is consolidated as a subsidiary.
- Where a fund has both a debt investment and a controlling equity position then the debt investment may be held at par assuming a change of control provision exists.
- Where a fund has an investment only in a debt instrument, or debt plus a non controlling equity position then the debt instrument is valued at FV.

Unit of Account

We believe that the unit of account guidance contained within existing IFRS standards is limited and ambiguous. IFRS 13 introduces the concept of the 'unit of account' – this is the first time it has been recognised explicitly within IFRS.

The principal references are:

- IFRS 13.14: *"the unit of account shall be determined in accordance with the IFRS that requires the fair value measurement, except as provided in this IFRS"*
- IFRS 13.BC47 *"In IAS39 and IFRS 9 the unit of account is generally an individual financial instrument"*

In many cases the unit of account can be inferred, however, for a financial asset that is an investment in a subsidiary, joint venture or associate it is not clear because the investment held by the entity comprises a number of individual shares or other instruments.

IFRS 13 also emphasises the market participant view:

- *"...fair value is a market based measurement, it is measured using the assumptions that market participants would use..."* (IFRS13.3)
- *"...an entity shall measure the fair value of an asset using the assumptions that market participants would use..."* (IFRS13.22)

What exceptions are anticipated in IFRS 13.BC47 through the use of "generally"?

Is this emphasis on a market participant view an exception anticipated in 13.14 allowing an entity to depart from the BC47 general assumption?

ASC Topic 946 under US GAAP is mostly silent on unit of account, which allows a market participant perspective to be used reflecting unit of account at an enterprise level.

Prior to the issuance of ASU 2011-4 and IFRS 13, limited unit of account guidance was mitigated through the "highest and best use" and "in-use" valuation premises. The ability to use market participant perspectives in assessing unit of account is diminished through the prohibition of using these concepts for financial instruments.

Consequences of unit of account being an individual share

We believe that there are two principal consequences of the unit of account being the individual share.

Firstly, value associated with control could not be recognised as this is unlikely to be a characteristic of an individual instrument. This would result in a day one loss where the purchase of an enterprise includes an identifiable or theoretical control premium and most importantly would provide unusable information for investors (what purpose is served for an investor to report an immediate loss only because of a unit of account interpretation?)

Secondly, the measurement of equity value would usually deduct debt at fair value (which may not equal par value) from enterprise value as change of control is unlikely to be triggered on the realisation of an individual share. This has the potential to overstate or understate the fair value of an equity instrument from the perspective of a market participant.

Industry view

We believe that the following represents an accurate summary of the view of valuation teams within the PE industry:

- Unit of account should be determined at the level of aggregation that a market participant would enter into an orderly transaction to maximise fair value. We believe that this is consistent with the concept of "value maximisation" within IFRS 13.BC67.
- Some private equity managers invest in multiple securities or tranches issued by the same portfolio company.
- If a potential buyer would be expected to purchase all securities/ tranche positions in the same underlying portfolio company simultaneously, then fair value would be measured for the aggregate investment in the portfolio company.
- If individual tranches of securities are purchased by market participants, then the unit of account and the basis for determining fair value would be the individual tranche
- Enterprise value is generally the best starting point for determining fair value, even for non-controlling positions.

Private equity returns are generally not disproportionate and when an enterprise is sold the minority owner receives the same pro-rata value as do the controlling shareholders.

- In addition, PE investors often work in concert with one another and value is realised through the sale of an underlying business.
- Compelling PE managers to treat an individual share as the unit of account would be fundamentally in conflict with the market participant approach and would result in financial information that is not meaningful to investors. Not having meaningful FV financial information could mean that investors are misstating the FV of their investment.
- In the "real world" nobody would buy or sell a single share in a private company in a standalone transaction. Why force people to assume hypothetical transactions that never occur with market participants who do not exist?
- This could be framed conceptually as allowing those entities qualifying as "Investment entities" under the new IFRS standard to establish Unit of Account at the level of aggregation at which the Investment Entity is expected to transact.

Guidance needed

We are seeking IASB guidance on the determination of unit of account for Level 2 and 3 financial assets and whether it is acceptable to establish the unit of account at the level the market participant is likely to transact (either on its own or in concert with other funds/ co-invest arrangements).

We would also welcome confirmation that a similar approach can be taken for minority positions (ie the starting point for the measurement of fair value would be the enterprise value) subject, depending on the facts and circumstances, to a potential discount (demonstrated to the extent applicable via calibration at entry) reflecting the inability of the owner of the minority position to direct the timing of a sale, if the owner is not working in concert with other investment entities.

Consequences if no IASB guidance

We believe that there would be a number of negative consequences if the IASB is unable to confirm an interpretation of unit of account which is consistent with how the private equity industry transacts:

- The uptake of IFRS across the private equity community would be extremely limited causing the efforts on the Investment Entity accounting framework to be undermined.

- Structural solutions might develop such that legal form dictates the accounting conclusion (for example, an 80% interest in a private company could be legally constructed as a single share).
- The same definition of fair value used in IFRS and US GAAP could result in different fair value estimates because of unit of account interpretations.
- The lack of convergence between IFRS and US GAAP would provide additional reasons for the US SEC to vote against adopting IFRS.
- Private equity firms would be likely to retain national or quasi national GAAP or migrate to US GAAP.
- Investors in private equity with US GAAP reporting obligations would have difficulty estimating and reporting the "US GAAP fair value" of their fund interests prepared using IFRS, if any, in their own financial statements and adjustments may be required.
- Investors in private equity with IFRS reporting obligations would have difficulty estimating and reporting "IFRS fair value" of their fund interests in their own IFRS financial statements given the day one loss imposed by a single share unit of account interpretation.