STAFF PAPER

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IASB Meeting

Project	**Fair Value Measurement—Unit of Account**
Paper topic	Next steps

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Purpose and structure of this paper

1. Both at the November 2015 and at this meeting, the staff have provided the Board with the relevant feedback and input gathered during the research work concerning the relevance of the measurement proposals in the Exposure Draft (ED) *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* that it requested from the staff at its meeting in July 2015. This paper outlines various alternatives available to the Board regarding the next steps and provides a staff recommendation.

2. This paper is structured as follows:

   (a) Background (see paragraphs 3–5);

   (b) Clarifications, measurement proposals and underlying reasons for the proposals in the Exposure Draft (see paragraphs 6–10);

   (c) The feedback gathered since the publication of the Exposure Draft (see paragraphs 11–13);

   (d) Additional input gathered since the publication of the Exposure Draft (see paragraphs (see paragraph 14);

   (e) Staff's analysis (see paragraphs 15–25); and

   (f) Conclusion and recommendation (see paragraphs 26–27).

Background

3. During the development of IFRS 13 *Fair Value Measurement* and the amendments to Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*®, the Board and the US national standard-setter, the Financial Accounting Standards Board (FASB), received questions about the unit of account for items measured at fair value that are made up of multiple individual financial instruments—that is, constituents wanted to know **what** they were measuring when measuring the fair value of an 'investment' (ie is it the investment as a whole or the individual financial instruments that make up the investment?). The Board and the FASB (jointly, 'the Boards') discussed this matter at their joint meeting in October 2010. At that meeting the Boards reaffirmed that the fair value measurement project was to address 'how' to measure fair value and not 'what' is being measured at fair value. They decided that clarifying the unit of account when measuring the fair value of an investment was outside the scope of the Fair Value Measurement project.[1]

4. Some constituents raised similar questions in December 2012 about the unit of account for investments in subsidiaries, joint ventures and associates that are within the scope of IFRS 10 *Consolidated Financial Statements*, IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*. The question arose because the measurement requirements for such investments in those Standards refer to IFRS 9 *Financial Instruments*, and IFRS 9 refers to the fair value measurement of individual financial instruments. In particular, the question was whether those references to IFRS 9 should be understood to:

   (a) refer only to the measurement basis of the investments (for example, fair value through profit or loss); or

   (b) also prescribe the unit of account of those investments (ie the individual financial instruments that make up the investment).

[1] This topic was discussed at the joint meeting in October 2010 (see IASB Agenda Paper 2E/FASB Agenda Paper 16 at: http://www.ifrs.org/Current-Projects/IASB-Projects/Fair-Value-Measurement/Summaries/Pages/IASB-October-2010.aspx).

5. In addition to the unit of account there was a second issue: the interaction between the use of Level 1 inputs and the unit or account for financial assets and cash-generating units (CGUs) and the interaction between the use of Level 1 inputs and IFRS 13's portfolio exception.[2]

Clarifications, measurement proposals and underlying reasons for the proposals in the Exposure Draft

Unit of account

6. As part of the work that led to the publication of the ED, a review of the Standards that might need amendments was undertaken. As part of this work, the following requirements of the following Standards were reviewed (**emphasis added**):

   (a) Paragraph 31 of IFRS 10: '[…]. Instead, an investment entity shall measure **an investment in a subsidiary** at fair value through profit or loss in accordance with IFRS 9.'

   (b) Paragraph 10 of IAS 27: 'When an entity prepares separate financial statements, it shall account for **investments in subsidiaries, joint ventures and associates** either:

      (a) at cost;

      (b) in accordance with IFRS 9; or

      (c) using the equity method as described in IAS 28.'

   (c) Paragraph 18 of IAS 28: 'When an **investment in an associate or a joint venture** is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities […], the entity may elect to measure **investments in those associates and joint ventures** at fair value through profit or loss in accordance with IFRS 9.'

7. In those requirements, the Standards refer to **investments in subsidiaries, joint ventures or associates** as being the unit of account for which the fair value measurement is required or permitted. On this basis, the unit of account was considered to be clear and did not warrant any further amendments.

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[2] At its April 2015 meeting, the Board decided that the illustrative example proposed in the Exposure Draft *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* appropriately illustrates the application of paragraph 48 of IFRS 13. In addition, the Board noted that the proposed illustrative example to IFRS 13 is non-authoritative, and the comments received did not reveal significant diversity in practice. Accordingly, the Board concluded that it was unnecessary to publish the proposed illustrative example in IFRS 13 as a separate document.

References to IFRS 9

8. Paragraph BC5 of the ED provides clarification about the references to IFRS 9 included in the requirements in IFRS 10, IAS 27 and IAS 28, which are reproduced in paragraph 6 of this paper:

BC5 The IASB noted that the references to IFRS 9 in those requirements were intended to ensure that entities use the requirements in IFRS 9 when:

(a) measuring investments at fair value through profit or loss. By referring to IFRS 9 instead of simply stating that the measurement was at fair value through profit of loss, it was intended that all of the requirements in IFRS 9 relevant to this measurement would apply. For example, the treatment of any differences between the fair value at initial recognition and the transaction price would be in accordance with IFRS 9.

(b) accounting for such investments in the entity's separate financial statements (for example, either by measuring those investments at fair value through profit or loss or by making an irrevocable election at initial recognition to present in other comprehensive income subsequent changes in the fair value of those investments when allowed).

Measurement proposals in the ED and the IASB's underlying rationale

9. The ED proposed that:

(a) the measurement of investments in subsidiaries, joint ventures and associates at fair value when these investments are quoted in an active market (quoted investments) should be based on the product of the quoted price for the individual financial instruments that make up the investment (P) and the quantity of financial instruments (Q), ie P × Q; and

(b) the recoverable amount of CGUs on the basis of fair value less costs of disposal when they correspond to entities that are quoted in an active market (quoted CGUs) should be the product of the quoted price (P) and the quantity of financial instruments held (Q), or P × Q.

10. The Basis for Conclusions of the ED outlined the underlying rationale for the proposals above (**emphasis added**):

BC9 The IASB proposes amending IFRS 10, IAS 27 and IAS 28 to clarify that **even though the unit of account for investments in subsidiaries, joint ventures and associates is the investment as a whole**, if those investments are made up of financial instruments that have a quoted price in an active market (ie a Level 1 input), the fair value measurement of those investments should be the product of the quoted price multiplied by the quantity of financial instruments held, without adjustments […].

BC10 The IASB reached this conclusion because it believes that the resulting measurements are **more relevant, objective and verifiable** when they are based on unadjusted Level 1 inputs (see paragraph BC168 of IFRS 13). In addition, the resulting measurements would also be more closely aligned with the following principles in IFRS 13:

(a) maximisation of the use of relevant observable inputs and minimisation of the use of unobservable inputs (see paragraph 61 of IFRS 13); and

(b) Level 1 inputs should be used without adjustments whenever they are available (see paragraphs 69, 77 and 80 of IFRS 13).

The feedback gathered since the publication of the ED

11. The majority of respondents to the ED agreed with the Board's proposals that the unit of account is the investment as a whole rather than the individual financial instruments included in those investments. However, the majority of respondents to the ED disagreed with the measurement proposals for both investments in subsidiaries, joint ventures and associates that are quoted in an active market (quoted investments) and for the measurement of the recoverable amount of CGUs on the basis of fair value less costs of disposal when those CGUs coincide with a quoted entity (quoted CGUs). The reasons provided by those respondents are similar to the reasons provided by some of the constituents with whom we have conducted outreach as part of the research undertaken on the measurement proposals of the ED (see Agenda Papers 6A and 6B discussed at the November 2015 Board meeting and Agenda Papers 6A and 6B discussed at this meeting).[3]

12. The views gathered on the measurement proposals in the ED during the research undertaken reflect that the majority of constituents think that the measurement resulting from applying P × Q would not be a relevant measurement for the unit of account being measured at fair value (ie the investment as a whole). There are, however, exceptions. Most of the users with whom we conducted outreach take, however, a pragmatic approach and prefer the measurement resulting from

[3] Agenda Papers 6A and 6B discussed at the November 2015 IASB meeting can be found at the following link: http://www.ifrs.org/Meetings/Pages/IASB-Meeting-November-2015.aspx

applying P × Q as a starting point. Some of them would then work out whether the quoted price is an appropriate input to measure the fair value of the investment or whether, in their view, it includes a degree of market noise that does not reflect the underlying cash flow-generating ability of the investee and that, if so, would then need to be stripped out. The measurement resulting from P × Q would also be the preferred measurement for a group of securities regulators that we contacted. Verifiability and transparency are the reasons why these regulators prefer P × Q rather than the use of a valuation technique. The academic literature review revealed that during the last 20 years the valuation profession has been debating whether the listed share prices of an entity on a stock exchange reflects the price of a minority interest or whether the listed share prices also incorporate control value and, consequently, whether the value of an entity could be derived from the listed price of its shares. Even though there is no firm consensus on this matter, there is a general understanding that every valuation needs to consider the specific facts and circumstances surrounding the item being measured at fair value. In addition, the academic literature review revealed that the general consensus is that the principal market of a controlling interest would be the mergers and acquisition market rather than the securities exchange market. These considerations may result in measurements different from the ones resulting from a direct application of P × Q (see Agenda Paper 6B).

13. The *Conceptual Framework for Financial Reporting* ('the Conceptual Framework') states that the fundamental characteristics of useful information are 'relevance' and 'faithful representation' (see paragraph QC5 of the *Conceptual Framework*). Yet in this case, what seems to constitute 'useful information' for users and for a group of securities regulators is 'verifiability', which is an enhancing (not a fundamental) qualitative characteristic of useful information (see paragraph QC19 of the *Conceptual Framework*). The reason for which most users and a group of securities regulators prefer a measurement resulting from applying P × Q is aligned to the underlying rationale for the measurement proposals provided by the Board in the ED (see paragraph 10).

Additional input gathered since the publication of the ED

14. As part of this research, in November 2015 the staff informed the Board of the results of an assessment of the population of entities that would be subject to the measurement proposals in the ED. On the basis of this exercise, it was noted that the number of entities with quoted investments in subsidiaries, joint ventures or associates to which the fair value measurement proposals would affect was deemed to be limited.[4] This was further corroborated by the feedback received from other constituents during the research exercise. In addition, for the case of quoted CGUs, according to the feedback received by many of the constituents contacted during the research, the population of CGUs that would correspond to quoted entities would also be limited (see Agenda Papers 6A and 6B of the November 2015 Board meeting).

Staff's analysis

15. Overall, the message received from constituents consulted since the ED was published is that a fair value measurement relying only on the listed prices of the shares may not always result in a relevant measurement for quoted investments and for measuring the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal. From our conversations with users, however, the message shared by a majority of them is that the measurements resulting from P × Q are objective and transparent and that they constitute their preferred starting-point when analysing those investments. In addition, we note that any clarification on the measurements for quoted investments or quoted CGUs will be of use for only a

[4] The requirements that would require or permit entities to measure investments in subsidiaries, joint ventures and associates at fair value are as follows: Paragraph 31 of IFRS 10 states: '[…] an investment entity shall not consolidate its subsidiaries or apply IFRS 3 when it obtains control of another entity. Instead, an investment entity shall measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9.'

Paragraph 18 of IAS 28 states: 'When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with IFRS 9.'

Paragraph 10 of IAS 27 states: 'When an entity prepares separate financial statements, it shall account for investment in subsidiaries, joint ventures and associates at either: (a) at cost; (b) in accordance with IFRS 9; or (c) using the equity method as described in IAS 28. […]'

very limited number of entities. The staff have identified the following alternatives regarding future directions for the project:

(a) Option 1—Continue with the measurement proposals in the ED;

(b) Option 2—Prioritise the principle of the unit of account;

(c) Option 3—Continue work on this area if this is identified as being a critical area in the Post-implementation Review (PIR) of IFRS 13.

16. The following paragraphs analyse these options.

Option 1—Continue with the measurement proposals in the ED

17. This option will represent a continuation with the measurement proposals in the ED. These proposals were rooted on the principle stated in IFRS 13 of maximising the use of observable inputs and using unadjusted Level 1 inputs (see paragraphs 69, 77 and 80 of IFRS 13). In paragraph BC9 of the ED, reproduced in paragraph 10 of this paper, the Board acknowledged that even though the unit of account for investments in subsidiaries, joint ventures and associates is the investment as a whole, the measurement proposals in the ED were preferable because they were more relevant, objective and verifiable.

18. The ED proposed to clarify the fair value measurements of quoted investments and quoted CGUs in a number of Standards. In addition to those amendments, some of the respondents to the ED identified that similar amendments could be extended to other Standards (IFRS 3 *Business Combinations* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations).* We think that the route of amending different Standards raises the risk that some transactions eligible for amendments may be missed. Consequently, if the Board were to choose Option 1, the staff recommend to the IASB that any needed amendments be included in IFRS 13.

19. The staff note that such an amendment in IFRS 13 would not impair convergence. On the contrary, it would contribute to clarify an area in which practices in both US GAAP and IFRS would be more closely aligned. However, if this option were also to be applied to the measurement of the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal, this would cause the fair value measurement of the recoverable amount of quoted CGUs to depart from US GAAP

requirements, in which control premiums are allowed to be considered for impairment testing purposes.[5]

20. If the Board were to opt for Option 1, the measurements would be easily verifiable. Users have perceived this as being key. However, those measurements are not perceived as being relevant by the majority of the respondents to the ED and by the majority of constituents contacted during the research exercise. An example of such a case that has been indicated to us by many constituents is when a controlling investor holds a controlling interest in an entity that has a portion of its shares trading in a market. Constituents argued that in such circumstances, the resulting fair value measurement of the controlling interest on the basis of the price of the shares that trade may not necessarily portray all the relevant features of that controlling interest and, consequently, result in a measurement that is not relevant. This would affect investment entities with investments in quoted subsidiaries and also the measurement of the recoverable amount of CGUs on the basis of fair value less costs of disposal, when those CGUs correspond to an entity that is quoted.

Option 2—Prioritise the principle of the unit of account

21. This option would clarify that an entity should respect the unit of account of the item that is being measured at fair value over the existence of Level 1 inputs when those Level 1 inputs do not correspond to the item (ie unit of account) being measured at fair value. We think that this option has the potential of resulting in measurements that are more relevant. However, it is also the option that is more susceptible to earnings management. If the Board were to opt for this option, the staff think that users' needs concerning the resulting measurements had P × Q being applied could be supplemented with additional disclosures.

22. The staff would also like to point out that this option would not, however, represent the intention in IFRS 13 to prioritise the use of Level 1 inputs even if the latter were not fully aligned to the unit of account being measured at fair value. The requirements in other Standards also support this view. For example,

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[5] Determining the Fair Value of a Reporting Unit (ASC Sections 350-20-35-22 and 35-23).

paragraph 21(b)(iii) of IFRS 12 *Disclosure of Interests in Other Entities* states (**emphasis added**):

> 21 An entity shall disclose:
>
> […]
>
> (b) for each joint venture and associate that is material to the reporting entity:
>
> […]
>
> (iii) if the joint venture or associate is accounted for using the equity method, **the fair value** of its investment in the joint venture or associate, if there is a quoted market price for the investment.

23. The staff note that the 'fair value' reference in paragraph 21(b)(iii) of IFRS 12 implicitly indicates that if those investments in quoted joint ventures and associates were measured at fair value, that fair value measurement would be on the basis of P × Q. Paragraph B44 of IFRS 3 represents a similar example:

> B44 This IFRS allows the acquirer to measure a non-controlling interest in the acquiree at its fair value at the acquisition date. Sometimes an acquirer will be able to measure the acquisition-date fair value of a **non-controlling interest on the basis of a quoted price in an active market for the equity shares** (ie those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the non-controlling interest using other valuation techniques.

24. If the Board were to choose this option, the clarification of which principle should be prioritised (ie the principle about the unit of account or the principle of maximising the use of Level 1 inputs) when those principles overlap would result in an amendment in IFRS 13. The Board would also need to consider that this option would result in a difference with US GAAP.[6]

Option 3—Continue work on this area if this is identified as being a critical area in the PIR of IFRS 13

25. This option would represent making use of the work carried out during this research exercise by feeding it into the Post-implementation Review (PIR) of IFRS 13. Further work on this topic would need to be reconsidered if the PIR

[6] The staff note that the clarification of which principle should be prioritised would not, however, cause departure between US GAAP and IFRS relating to the measurement of the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal.

identified this as a critical area in which entities encountered significant problems when implementing the Standard.

Conclusion and recommendation

26. On the basis of the work performed on this research, we do not think that there is strong evidence that the issue is widespread or that there is divergence in practice that needs to be dealt with by amendments to Standards. We think that the entities that would benefit from any clarifications are limited and that the costs would not outweigh the benefits.[7]

27. We think that the PIR of IFRS 13, which is planned to take place during this year, will represent a better setting for testing this conclusion. In particular, the staff think that the PIR would also be a better setting to consider the feedback provided by the majority of constituents concerning the lack of relevance of the resulting proposed measurements not only for investments within the scope of the ED but also for investments beyond the scope of the ED (for example, holdings within the scope of IFRS 9). If this area is identified as being critical, the PIR will most probably also provide further details and evidence for specific amendments that are needed, and may provide a justification for why the relating costs of clarifying the fair value measurement, either on the basis of Option 1 or Option 2, through specific amendments, are worth incurring. Consequently, the staff recommend to the Board that it should pursue Option 3.

Question to the IASB

Question
Does the IASB agree with the analysis and the staff recommendation?

[7] Please note that the assessment of the population of entities that was undertaken has its limitations because it does not encompass all the situations in which the measurement proposals of the ED would apply (see Agenda Paper 6B presented in November 2015). However the assessment still provides an indication that it is informative.