



Project **Financial Instruments: Recognition and Measurement**

Topic **Equity instruments: cost exemption**

Background

Introduction

1. IAS 39 requires all equity instruments and derivatives on such equity instruments within its scope to be measured at fair value, with one exemption - unquoted equity instruments and some derivatives linked to such investments if fair value cannot be determined reliably. If the conditions for the exemption are met the financial instrument must be carried at cost less impairment.

Purpose of the paper

2. The objective of this paper is to provide a basis for a Board decision about whether the cost exemption for unquoted equity instruments (and related derivatives) should be kept or removed in a future exposure draft (ED) on classification and measurement.
3. To meet this objective this paper provides an overview over the existing guidance, a staff analysis and a staff recommendation (set out in paragraphs 29-35).

Current requirements of IAS 39

4. IAS 39 requires all equity instruments to be measured at fair value. Depending on the measurement category of the instruments (fair value through profit or

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loss/available for sale) changes in fair value are recognised either in profit or loss or in other comprehensive income (OCI).

5. IAS 39.46(c) contains an exemption from fair value measurement for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. This exemption is extended to derivatives over such equity instruments that are physically settled by delivering the equity instrument. In that case the instrument is measured at cost less impairment. This exemption is mandatory.
6. IAS 39.AG80 provides guidance when fair value is *presumed* to be reliably measurable:
 - (a) when the variability in the range of reasonable fair value estimates is not significant for that instrument; or
 - (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
7. If both conditions are not met it is presumed that fair value is not reliably measurable and the entity is precluded from measuring the instrument at fair value.
8. IAS 39.81 notes that there are many situations in which the variability in the range of reasonable fair value estimates for such instruments is likely not to be significant and that it is normally possible to estimate the fair value of a financial asset that an entity has acquired from an outside party.
9. For unquoted equity instruments required to be measured at cost (and linked derivatives that are assets) an impairment test is required. If there is objective evidence that an impairment loss has been incurred, the impairment loss is measured as the difference between the carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. No reversals for impairment losses are permitted.
10. In addition, IFRS 7 *Financial Instruments: Disclosures* exempts such instruments from the required fair value disclosures. Instead, it requires other

qualitative and quantitative disclosures to enable users to make their own judgements about possible differences between carrying amount and fair value.

Staff analysis

11. The Basis for Conclusions to IAS 39 does not contain a discussion why the Board considered such an exemption necessary.
12. From the guidance in IAS 39 it can be concluded that reliability was the underlying rationale for providing this exemption. Some would argue that reporting the volatility resulting from an unreliable measurement of fair value would distort the reported financial performance of an entity and does not reflect economic reality.
13. It is also clear from IAS 39.AG81 that the Board at that time believed that even for unquoted equity instruments and physically settled derivatives linked to them fair value normally can be determined reliably. This would imply that only few financial instruments are carried at cost less impairment.
14. However, the staff wants to highlight that anecdotal evidence shows that the exemption is used broadly in practice. The reason for this broad application in practice is the emphasis on “unquoted” compared to reliability of fair value measurement. As a consequence the exemption is applied as a rebuttable presumption, ie for unquoted equity instruments and derivatives linked to such investments fair value is deemed to be not reliably determinable unless proven otherwise.
15. The staff notes that in its ongoing Framework project the Board has replaced the notion of reliability with faithful representation; a measurement faithfully represents an economic phenomenon when the information depicted is complete, neutral, and free from error.
16. Further, the staff believes that the information value to users of a cost-based measurement for instruments with no contractual cash flows is low. This is particularly true if the investment was acquired in the early stages of an investee.

In many cases fair value will be significantly different to the cost information reported. In that case cost information will only reflect the maximum loss exposure from the investment, but no possible appreciation in value.

17. The staff acknowledges that the costs of generating fair value information should also be assessed in deciding whether a cost exemption is appropriate. This is particularly true for the cost of obtaining the inputs necessary to perform a valuation (although, of course, this is not limited to equity investments).
18. Basic shareholder rights generally enable an entity to obtain the necessary information to perform a valuation (e.g. based on earnings multiples or using a DCF method). The information availability, and quality, also depends on the type of involvement, ie whether the reporting entity is a passive shareholder or actively engaged in management (but does not control or have significant influence over the investee).
19. In addition, valuation methodologies¹ have advanced over recent years which increased the reliability of the techniques. This point has also been made by some respondents to the Discussion Paper *Reducing Complexity in Financial Reporting* and was also made by some in responses to the JWG Exposure Draft in 2001.
20. In addition, it should be noted that even with the cost exemption, entities are required to monitor the investments for impairment and possibly calculate any impairment loss, unless the Board provides a cost exemption without any impairment requirements.
21. Moreover, the current exemption to fair value measurement has often been criticised for requiring an impairment loss to be recognised that is based on a calculation that is close or equal to a fair value determination. However, this does not change the reliability of measurement and it seems a function of conservatism to allow recognition of an impairment loss on that basis.

¹ While this might be true, the staff wants to highlight that the availability of resources to apply these methodologies might not be distributed evenly around the world.

22. Finally, exemptions from measurement principles are a source of complexity for an accounting standard. Hence, removing this exemption would reduce complexity of a standard. While there might be increased complexity in determining fair values for preparers, this would be offset by abandoning the requirement to monitor the instruments for impairment. Clearly users would benefit from more relevant information.

Alternatives

23. The Board has at least three alternatives to approach the cost exemption in IAS 39:
- (a) do not change the existing cost exemption;²
 - (b) remove the cost exemption; or
 - (c) modify the existing cost exemption in some way.
24. The first two alternatives need no further explanation.
25. There may be many different approaches to alternative (c).
26. One approach to alternative (c) would be to remove the notion of “unquoted”, and to require an exemption in only ‘rare’ circumstances. However, any such exemption should make clear that current and upcoming guidance on determining fair value in IFRSs for almost all cases lead to a reliable measurement that is representationally faithful and provides more relevant information to users of financial statements than cost.
27. In essence, a cost measurement would be required if the information value for users is so degraded because the fair value is considered to be so unreliable. That clearly would require significant judgement from the reporting entity.

² A minority of the staff believes due to the challenges some entities might face in determining fair value retaining the exemption as it stands would be the best way forward.

28. This alternative would also require re-consideration of the impairment model to remove the inherent conflict that exists in today's requirements.

Staff recommendation

29. **The staff recommends eliminating the cost exemption for equity instruments and derivatives over such equity instruments that are physically settled by delivering the underlying accounted for under the financial instruments standard.** As a consequence, such equity instruments would be reported at fair value. Consequentially, related disclosures in IFRS 7 should be removed.
30. Reporting equity instruments and derivatives at fair value provides the most relevant information to users as discussed in previous papers. Conversely, reporting any of these instruments at cost is of less, if any, value for users.
31. The Board's current thinking in the Framework project indicates that reliability as it has been interpreted by many is not the primary focus of financial reporting. It should rather depict, in a representationally faithful manner, economic reality. Fair value best reflects economic reality, at the reporting date, for such instruments, particularly compared to cost.
32. The staff acknowledges that any fair value information reported has to be representationally faithful in order to be relevant. The fair values of all such instruments would be level 3 fair values. However, this does not preempt the measurement as unreliable. Many other financial instruments, especially derivatives, involve a high degree of judgement in determining fair value. Authoritative and educational guidance available provide a sufficient basis to arrive at reliable fair value measurements.
33. Furthermore, reporting entities will have to incur additional costs in determining fair values for such instruments, particularly in jurisdictions where these types of investments are common. This is aggravated by the fact that such information potentially would have to be generated for any required interim reports. On the

contrary, the requirement to monitor the investments for impairment and to determine any impairment loss would cease to apply resulting in a reduction in cost.

34. Finally, removing the exemption would also resolve the inherent conflict with the current requirement that any impairment would have to be recognised on the basis of future cash flows. However, an equity instrument has no contractual cash flows – value is realized by receipt of (discretionary) dividends and changes in value. In fact, the impairment process approximates a fair value determination and is by no means more reliable than fair value itself.
35. On balance, the staff believes that the benefits from removing the cost exemptions and reporting such instruments at fair value outweigh the cost involved.

Questions to the Board

Does the Board agree with the staff recommendation to remove the cost exemption for certain unquoted equity instruments and related derivatives?

If not, what do Board members wish to do, and why?