



Project	Financial Instruments: Replacement of IAS 39: <i>Financial Instruments: Recognition and Measurement</i>
Topic	Redeliberation of ED/2009/7 <i>Financial Instruments: Classification and Measurement</i> – Exception from fair value measurement for some equity instruments

Purpose of this paper

- 1. This paper addresses the proposed elimination of the cost exception for some unquoted equity instruments and related derivatives.**
- The paper provides:
 - (a) an overview of the proposals in the exposure draft ('the ED') (paragraphs 3-10);
 - (b) an overview of the FASB's tentative decisions (paragraphs 11-13);
 - (c) a staff analysis of comments received from constituents (paragraphs 14-39);
 - (d) possible alternatives for the Board (paragraphs 40-47); and
 - (e) a staff recommendation to finalise the guidance as proposed (set out in paragraphs 48-49).

Overview of proposals in the ED

3. ED/2009/7 *Financial Instruments: Classification and Measurement* proposes that all equity instruments within the scope of IAS 39 are measured at fair value as their contractual terms do not give rise on specified dates to cash flows that

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

are payments of principal and interest and hence fail the basic loan feature criterion. Changes in fair value would be recognised in profit or loss for the period unless the other comprehensive income (OCI) presentation option¹ is available and used.

4. As a result, the current exception in IAS 39.46(c) & .47(a) for investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such equity instruments was proposed to be eliminated. This measurement exception in IAS 39 provided for cost accounting and, in the case the instrument concerned was a financial asset, an impairment requirement.²
5. Several reasons led the Board to conclude that the elimination of the exception would improve reporting for financial instruments (see BC61-BC66 of the ED).
6. For investments in equity instruments and derivatives fair value provides the most relevant information. Cost provides little, if any, predictive value about the timing, amount and uncertainty of the future cash flows arising from the instrument. In many cases, fair value will differ significantly from historical cost (this is particularly true for derivatives measured at cost under the exception).
7. To ensure that a financial asset accounted for under the cost exception is not carried above its recoverable amount, IAS 39 requires an entity to monitor instruments measured at cost for any impairment. The calculation of any impairment loss is similar to determining fair value (ie, the estimated future cash flows are discounted using the current market rate of return for a similar financial asset and compared with the carrying amount).
8. Further, removing the exception would reduce complexity as the classification model for financial instruments would not have a third measurement attribute

¹ The proposed OCI presentation alternative is available on initial recognition for investments in equity instruments that are not held for trading. If invoked all gains or losses (including dividends) on the instrument are recognised in OCI and are not recycled subsequently.

² See agenda paper 3B of the 1 June 2009 meeting for a comprehensive discussion.

and require an additional impairment methodology³. While there might be an increase in the complexity of determining fair values on a recurring basis that complexity would be offset (at least partially) by the fact that all equity instruments and derivatives have one common measurement attribute, and the impairment requirements would be eliminated.

9. The Board also noted that valuation methodologies and expertise and the availability of the information required to perform valuations are more broadly available and generally accepted.⁴ It was noted that basic shareholder rights usually enable an entity to obtain the required information to determine fair value using generally accepted valuation methodologies.
10. However, the additional cost of fair valuing all equity instruments that are currently measured at cost (less impairment) further depends on the reporting entity and might be considerable for some entities. The Board acknowledged that it cannot perform a comprehensive cost/benefit analysis and decided to ask specific questions on the proposed removal of the cost exception.

Overview of the FASB's tentative decisions

11. Current US guidance requires all investments in equity instruments with readily determinable fair values⁵ to be measured at fair value. All other investments in equity instruments that are not accounted for under other methods (eg the equity method) are measured at cost. The effect of these requirements is that IFRS and US GAAP reach similar conclusions on which equity instruments are carried at cost and which are carried at fair value.
12. Derivative contracts that are physically settled by delivering such investments in unquoted equity instruments fail the definition of a derivative under US GAAP

³ The staff notes that neither the current incurred loss or the currently deliberated expected cash flow approach can be applied to equity instruments.

⁴ The staff acknowledges that valuation expertise might not be distributed evenly around the globe.

⁵ This is a defined term under the US GAAP codification, in effect narrowing down the scope of instruments.

as the underlying must be readily convertible to cash if the contract is physically settled.⁶

13. The FASB tentatively decided to amend its existing guidance to require fair value measurement for all equity instruments within the scope of its financial instruments project through profit or loss. This is consistent with the proposals in the IASB ED.

Staff analysis of comments received from constituents

14. The exposure draft asked constituents for input on the following two questions:
 - (a) **Question 8:** Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?
 - (b) **Question 9:** Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Feedback from constituents (comment letters and outreach activities)

15. Many respondents agreed that cost does not provide useful information about future cash flows arising from equity instruments and that conceptually fair value (or maybe some other current measurement) is the right answer. Some of those respondents generally agreed with the removal of the exception, but

⁶ However, SEC requirements bring some written options into the scope of SFAS 133.

pointed out that disclosures would have to inform about the uncertainties surrounding measurement.

16. However, many respondents (mainly preparers from non-financial entities and some auditors) disagreed with the proposal to eliminate the current cost exception based on the following grounds:
 - (a) Reliability and decision-usefulness of fair value measurement
 - (b) Cost and difficulty involved in determining fair value on a recurring basis – in particular compared to the incremental benefits to users
 - (c) Verifiability of fair value information
 - (d) Impaired comparability due to subjectivity of measurement
17. Those respondents generally preferred to keep the cost exception as per the current guidance in IAS 39. Some noted that the proposals would not reduce complexity, but merely shift it towards the actual measurement exercise. Further, a few commentators believed that cost could provide useful information if the instrument is held for the long term. Some respondents noted that there is interaction with the OCI presentation alternative set out in the ED.
18. **Reliability of a calculated fair value.** Respondents noted that IAS 39 currently has the cost exception included because of the lack of reliability of fair value measurement for particular equity instruments – some believed this rationale is still valid. Hence, they asserted that fair value information is not useful to users because of the lack of reliability. Respondents noted that given the lack of available reliable information, any fair value measurement would require significant management judgment or is even impossible (eg due to the lack of resources to perform a valuation). Some respondents also noted that many different valuation techniques could be used, each of which may yield a significantly different result, and it was normally not obvious which method to use or how to weight different methods.
19. Respondents noted that given the wide range of ‘fair values’ that might be calculated, including the one fair value number that is recognized in the

accounts, would mislead users. Users, they argued, would place reliance upon the fair value without any appreciation or understanding about the fact that possible ranges of different fair value numbers that could have been used. Some respondents seemed more concerned about this issue in the context of fair value *increases* above cost (which is theoretically unlimited). Some respondents believed that for impairment a lower reliability threshold was acceptable as a reflection of (one sided) prudence and hence the existing impairment model was appropriate.

20. Some respondents highlighted that due to the range of possible fair values comparability between entities could potentially be impaired as different entities could arrive at completely different fair values for the same investment.
21. **Cost and difficulty in calculating fair value.** As noted above, many respondents noted that they faced significant difficulty in obtaining useful information that might be relied upon to use in any valuation attempt. Such information was often not available, and even if it was available there was often a significant time delay before it was available. Respondents with investments in emerging economies stated that they faced particular difficulties. However, other respondents noted that these difficulties and the cost aspect are not insurmountable and for material items generally the benefits to users outweigh the cost to preparers.
22. Some respondents noted that they did not have internal expertise, and even in situations that such expertise was available they inevitably would rely heavily on external experts. Such reliance obviously resulted in significant cost. Some auditors also noted the difficulty in verifying fair values, and the costs that preparers faced.
23. Many respondents that did not agree with the removal of the cost exception emphasised that a requirement to determine fair value on a recurring basis (often quarterly) was not practicable (for example, information was not available – see above) and would involve significant costs and efforts which they believe is not offset by the incremental benefit to decision usefulness from fair value

measurement. In contrast under the existing impairment model, because a quantitative assessment of an impairment loss would only have to be made if particular triggers were met, there is no requirement to determine a fair value-like amount on a recurring basis.

24. Some respondents however believed that the argument was not relevant that measuring fair value for complex derivatives was required, and that such valuations sometimes were significantly more difficult (both in terms of valuation models and unobservable inputs) than for equity investments. For example, non-financial entities noted that such instruments were often held by financial institutions that have significant internal valuation expertise, whereas many unquoted equity investments were held by non-financial entities that did not possess such expertise.
25. Some respondents suggested that instead of removing the cost exception, the Board could try to reinforce that the guidance is not intended to provide for a cost *option*, but rather that it is a measurement *exception* that applies in narrow circumstances. That is, that a fair value measurement can be reliably made in almost all situations.
26. Other respondents noted that if the Board proceeds with the proposal to eliminate the cost exception then the Board should consider possible measures to reduce the cost to preparers. One suggestion was that valuations should be required only for annual financial statements, unless the entity received information that suggested there had been a significant change in the fair value of the investment⁷.
27. Other commentators suggested that any final standard on fair value measurement should contain guidance on how to determine the fair value for unquoted equity instruments and related derivatives and pointed to existing industry practice guidance for private equity valuation (eg *International Private Equity and Venture Capital (IPEV) Valuation Guidelines*) and guidance being

⁷ However, staff notes that this argument could be made for other types of financial instruments.

developed under US GAAP (FSP 157-g *Estimating the Fair Value of Investments in Investment Companies That Have Calculated Net Asset Value per Share in Accordance with the AICPA Audit and Accounting Guide*). Others noted that they believed the IASB's ED *Fair Value Measurement* provides sufficient room to conclude that cost could represent a fair value under specific circumstances.

Staff analysis

28. The staff notes that most arguments brought forward against the removal of the cost exception had been considered by the Board during the deliberation phase of the ED.
29. Many respondents raised the argument of reliability of fair value for the instruments concerned in isolation. However, the *Framework* has four qualitative characteristics that make information decision-useful. Besides reliability these are: understandability, relevance and comparability. So the decision whether information is considered useful is based on an assessment of all of these criteria. In this case, cost is a very reliable (and objective) amount, but has little, if any, relevance.
30. We think that respondents in favour of retaining the exception overemphasise the element of uncertainty when assessing reliability. However, reliability is not the opposite of uncertainty. Many items recognised under IFRS bear an element of measurement uncertainty – equity instruments are no exception.
31. In the staff's view fair valuing all equity instruments, including those that are currently measured using the cost exception, meet the criteria⁸ in the *Framework* for information to be reliable if appropriate measurement techniques and inputs

⁸ Faithful representation, substance over form, neutrality, prudence and completeness (F. 33-38).

are employed⁹ (the IASB's project on fair value measurement will provide guidance on how to meet that objective).

32. The staff thinks that providing users with cost information has little value—and any information value is diminishing over the holding period (ie the longer an entity holds an equity instrument the less predictive power – if any – cost information has). No respondent proposed a current measurement method with a clear measurement objective as an alternative to fair value or cost.
33. However, the staff acknowledges that the cost involved in determining fair value for items currently accounted for under the cost exception could be significant, in particular relative to the value of the instruments. This is aggravated by the frequency of measurement – potentially fair values have to be determined every quarter (depending on the reporting frequency of the entity). Some of these costs might be mitigated by, for example, not requiring remeasurements quarterly unless the entity received information that suggested the value of the investment had changed significantly.
34. If it can be established that the incremental benefit to users is outweighed by the cost involved from requiring fair value measurement then the staff believes that an exception could not be justified under the Framework (see ED question below).

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

Feedback from constituents (comment letters and outreach activities)

35. Constituents highlighted that in some jurisdictions entities hold high numbers of unquoted equity instruments that are currently accounted for under the cost exception where the value of the single investments is considered low.

⁹ Ultimately, ensuring that the measurement technique and inputs to such a technique are appropriate cannot be established by a standard setter, but by preparers, auditors, regulators and enforcers.

36. Those constituents argued that the cost of determining fair value for every single instrument would outweigh the benefits and that, due to the nature of equity instruments, aggregation is not possible (which would decrease the total cost of measurement for preparers). From the responses received it was evident that the exception is more widely used than originally intended by the Board.

Staff analysis

37. The staff agrees with the analysis presented by constituents that there are circumstances where the cost of determining fair value outweigh the benefits from fair value measurement.
38. However, the staff thinks this analysis is more relevant when assessing materiality rather than whether fair value is relevant. As stated in previous papers the staff notes that the concept of materiality applies universally – unquoted equity instruments and related derivatives would be no exception.
39. However, the staff notes that if the volume of the investments individually or aggregated is material the incremental benefit of fair value generally outweighs the additional cost due to the impact of the investments on the financial performance and position of the entity – in particular compared to the measurement alternative (which also involves cost for preparers).

Possible alternatives for the Board

40. We think the Board has the following options for finalising the proposals:
- (a) Finalise the proposals without modification, but consider whether there are ways in which the cost to preparers might be reduced.
 - (b) Keep the existing exception in IAS 39 *without* modifications.
 - (c) Keep the existing exception in IAS 39 *with* modifications.
41. The first two options need no further explanation. With regard to the third option the Board can approach this in various ways.

42. One approach could be based on the feedback received that the Board could reinforce the exception to make clear that it is not a cost *option*, but rather that it is a measurement *exception* that applies in narrow circumstances. That is, that a fair value measurement can be reliably made in almost all situations.
43. The staff notes that the recently issued ED *Fair Value Measurement* contains no guidance as to when a level 3 measurement might be considered unreliable.
44. Putting more emphasis on lacking reliable measurement inevitably raises the question whether the equity instrument should be recognised in the first place in the statement of financial position. The *Framework* states that if an item is so unreliable in nature or representation that its recognition might be potentially misleading then the item should not be recognised (and hence, no issue with subsequent measurement arises)¹⁰. Therefore, as a variant to keeping the cost exception, including the unavoidable impairment requirements, another approach could be to require recognition of the consideration paid on the date of transaction as an immediate expense. (One participant at the Tokyo roundtable suggested this possibility).
45. This approach (and its underlying rationale) is similar to that followed for the “expense as incurred” approach for research expenditures in IAS 38 *Intangible Assets*.
46. The staff thinks, while not recommending this variant, that if the Board wishes to keep an exception from fair value measurement for certain equity instruments on the grounds of reliability concerns it should consider this accounting treatment.
47. Other approaches to address option (c) include:
- (a) provide new/more guidance on when fair value is not reliably determinable. However, such guidance should arguably be addressed as part of the Fair Value Measurement project.

¹⁰ Framework, paragraph 32.

- (b) provide new/additional guidance on the impairment requirements
- (c) add a rebuttable presumption that fair value is reliably determinable even if an equity instrument is unquoted.

Staff recommendation

48. **The staff thinks that all equity investments and derivatives should be measured using one measurement attribute. The measurement attribute that has been identified to be most relevant is fair value. As a result, we recommend that the IFRS carries forward the proposal in the exposure draft to eliminate the exception in IAS 39 that requires unquoted equity instruments where fair value is not reliably determinable and physically settled derivatives linked to such instruments to be measured at cost.**
49. The staff notes that the commentators have not brought forward significant new arguments that the Board had not already discussed in the deliberation phase, in particular on considerations about reliability and cost.
50. However, the staff recommends making clear in the Basis for Conclusions that the Board made the decision to remove the cost exception considering that the concept of materiality applies to these investments – as it does to every item in the financial statements, ie many of these investments will continue not to be remeasured on a recurring basis because of materiality considerations. The final guidance should also point to the relevant portions of the final standard on fair value measurement for guidance on **how** to determine fair value of such equity instruments (once that document has been finalised). The staff believes this would also address concerns over the cost involved.

Elimination of the cost exception

Does the Board agree with the staff recommendation to finalise the proposals in the ED that eliminate the cost exception in IAS 39 for investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured (and derivatives that are linked to and must be settled by delivery of such equity instruments)?

If not, why and what does the Board wish to do instead, and why?

51. As previously mentioned another way to alleviate the cost that would be incurred if fair value was to be required on a recurring basis for equity instruments currently accounted for under the cost exception would be to waive the requirement to determine fair value for interim financial reports.
52. To avoid significant time delays in reporting significant changes in the value of such equity instruments any guidance should make clear that the relief can only be invoked if there is no evidence that a significant change in fair value has occurred.
53. As it is proposed to remove the cost exception there will be no guidance to what type of equity instruments this measurement relief could be applied to. Hence, the staff proposes to restrict the measurement relief to all unquoted equity instruments not held for trading.
54. **The staff recommends amending IAS 34 *Interim Financial Reporting* to exempt from determining fair value at an interim reporting date investments in unquoted equity instruments that are not held for trading if there is no evidence of a significant change in fair value since the last date when fair value was determined.**
55. This relief would only be applicable for interim financial reports – an entity would at least be required to determine fair value for annual reports.
56. Entities would not be required to use this voluntary relief. However, if an entity uses the relief it should disclose that fact.

57. The staff thinks that it is necessary to exclude unquoted equity instruments held for trading from that relief as we think it is important that users receive, on a timely basis, information about held for trading instruments including derivatives.

Relief from fair value measurement for interim financial reports

Does the Board agree with the staff recommendation to amend IAS 34 to provide voluntary relief from determining fair value at interim reporting dates for unquoted equity instruments that are not held for trading if there is no evidence of a significant change in fair value since the last date when fair value was determined?

If not, why and what does the Board wish to do, and why?