IASB Meeting | Agenda reference **4**

Staff Paper | Date **29/09/2009**

Project	**Financial Instruments: Replacement of IAS 39: *Financial Instruments: Recognition and Measurement***
Topic	**Exemption from fair value measurement for some unquoted equity instruments**

Purpose of this paper

1. **This paper aims to clarify the Board's decisions on agenda paper 2 at the 22 September 2009 additional meeting. It further asks for additional decisions to enable the staff starting to draft the final guidance on this issue.**

Summary of the Board decisions

2. At the 22 September additional meeting the Board started the redeliberations of ED/2009/7 *Financial Instruments: Classification and Measurement* ('the ED') with discussions on the proposed elimination of the cost exception 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.

3. The staff recommended carrying forward the proposals in the ED to eliminate the cost exception.[1] As a consequence, all equity instruments and related derivatives would had been measured at fair value. One staff member expressed his concerns over the recommendation in the context of emerging economies, in particular cost and availability of data and expertise.

[1] See paragraph 48 of agenda paper 2 of the 22 September meeting.

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.

4. Some Board members disagreed with the staff recommendation that fair value in **all** circumstances should be used for equity instruments. Those Board members presented different reasons for that conclusion, including the practicality of some types of entities being able to obtain the required input information and having the ability to use that information and the usefulness of such a number given the challenges in ascertaining it.

5. The Board had an extended debate on keeping the cost exception or at least providing some simplified approach to measurement that was sufficiently close to fair value as currently defined in IAS 39 *Financial Instruments: Recognition and Measurement* (ie a measurement exemption) if fair value measurement was impracticable[2].

6. At least one Board member favoured the expense as incurred approach as set out in the agenda paper.[3] Others preferred a simplified valuation methodology based on share in net assets.

7. There seemed to be no support to keeping the cost exception as currently contained in IAS 39.

8. However, there seemed to be agreement around the table that for some equity instruments fair value measurement should not be required – the question now is when and what the alternative measurement should be.

When to apply a measurement different from fair value

9. To qualify for a measurement exemption one criterion or multiple criteria have to be determined to identify the equity instruments to which a different measurement could be applied to.

[2] There seemed to be agreement amongst Board members that "impracticable" should be used as defined in IAS 8.5.

[3] See paragraphs 44-46 of agenda paper 2 of the 22 September meeting.

10. At the meeting on 22 September, Board members discussed various approaches how to identify these instruments, including approaches based on:

    (a) the type of reporting entity;

    (b) the reliability of measurement;

    (c) the materiality of the item; or

    (d) the efforts required to perform the actual measurement.

11. The Board decided that this criterion could be based on the impracticability of determining fair value. In the staff's view it was evident from the discussion that Board members had the definition of impracticable[4] in IAS 8.5 in mind.

12. The staff believes that the term "impracticable" is a criterion that narrows down the subset of instruments sufficiently as eg financial institutions generally cannot invoke this exemption as it would be difficult, if not impossible, for them to establish that it is impracticable to determine a fair value.

13. However, the staff believes that "impracticable" is not a nullset, ie "impracticable" in the basic definition in IAS 8.5 does not mean "impossible". The staff believes practice does not interpret "impracticable" in that narrow meaning.

14. The major advantage of using the notion of "impracticable" would be that no new guidance would have to be developed – the existing definition in IAS 8.5 would be used.

15. The staff considered using a notion of "undue cost or effort". However, we think that "impracticable" is a more objective attribute as "undue cost or effort" is based on management's *ex ante* assessment of financial and human resources that would be required to meet a requirement. Further, that term is neither

[4] "[A]pplying a requirement is impracticable when the entity cannot apply it after making every effort to do so. […]"

defined nor used in current IFRS[5]. This would inevitably lead to developing new guidance.

Alternative measurement

16. Once the circumstances have been identified that render an alternative measurement permissible, the alternative measurement has to be determined.

17. At the last meeting the Board discussed various approaches to a (simplified) measurement for some unquoted equity instruments. The candidates discussed were:

    (a) Management's best estimate of the price they would accept to sell (or buy) the instrument

    (b) (Changes in) share in net assets (SINA)[6]

    (c) Cost (potentially less impairment)

18. An approach based on management's sell/buy price would be highly subjective. Such an approach is unlikely to result in a 'fair value' number, although it may approximate to one. This approach would require an entity to obtain sufficient input information and have the ability to use that information to arrive at such an estimate. It is also unclear whether users of financial statements would use such a number for analysis, and if so how such a number would be used.

19. A SINA approach seemed to be favoured by a majority of Board members. While acknowledging the advantages of this approach, in particular its perceived

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[5] However, this notion is used in multiple instances in the IFRS for SMEs, but without providing a definition or further guidance how to interpret the term.

[6] At the meeting there were references to existing and draft US guidance on share in net assets. The staff wishes to highlight that this would only apply in a narrow subset of situations and to a narrow subset of entities – investment companies. The draft guidance refers to the investment companies Guide which, among other requirements, indicates that in arriving at the investee's net asset value per share, the investee must measure all of its underlying investments at fair value in accordance with Statement 157. The draft guidance also notes that investment companies regularly stand ready to redeem the investment for net asset value per share, and thus net asset value per share is a good indication of the price the investor would receive to sell its investment.

simplicity, the staff believes that an approach based on SINA has significant disadvantages:

(a) The SINA approach has no clearly defined measurement objective.

(b) It assumes the investee produces financial statements in an acceptable and timely manner. This should not be taken as a given in some jurisdictions.

(c) The financial statements of the investee can be based on various types of GAAP (IFRS, US GAAP, local GAAP, tax law, cash basis) potentially invalidating the presumption of that value being a proxy for fair value. Furthermore, due to the lack of significant influence, it would be difficult for the investor to require the investee to generate IFRS compliant information.

(d) If significant amounts of unrecognized and/or cost-based items exist SINA is not a good indicator of fair value (eg an R&D company) and would require adjustments.

(e) If any adjustments are required to arrive at a better estimation of fair value this would contradict the underlying rationale to reduce the cost for preparers – and it would require additional guidance in the final standard.

(f) The guidance some referred to that exists under US GAAP is industry-specific (investment companies) and difficult, if not impossible, to transform into guidance that is applicable to all entities. (See previous footnote).

20. Overall, the staff thinks that a SINA approach does not result in significantly better information for users to enable them to assess the amount, timing and uncertainty of future cash flows compared to a cost-based approach.

21. Hence, the staff recommends not further pursuing a SINA measurement approach[7].

Cost measurement

22. The staff thinks that if the Board wishes to address the concerns regarding an entity's ability to obtain sufficient input information and have the ability to use that information then the Board should consider keeping a form of cost[8] measurement.

23. Hence, the staff recommends providing for cost measurement in cases where it is impracticable to determine fair value.

Impairment

24. Permitting cost measurement raises the question about the impairment model required to ensure the asset is not carried above its recoverable amount. Both the Board and constituents have identified the current impairment model for items carried at cost as complex and akin to a fair value measurement.

25. We think the Board has no intention **not** to require any form of impairment test. So an impairment model is required.

26. Instead of having a distinct impairment model as under current IAS 39 the Board could consider referring to IAS 36 *Impairment of Assets*. IAS 36 already applies to investments in subsidiaries, associates and joint ventures carried at cost in the separate financial statements (see paragraph 4 of IAS 36).

27. However, as under that guidance impracticability of fair value measurement is not a pre-requisite, an entity is assumed to be able to determine both "fair value

[7] Appendix A sets out further considerations in case the Board wishes to pursue a SINA approach.
[8] The paper uses the term cost for the amount recognised on initial recognition, ie fair value on day 1 as required by IAS 39.43. This amount is carried forward unless an impairment (if required) occurs.

less cost to sell" and "value in use". For purposes of this exemption, only the 'value in use' methodology can be used – fair value has already been identified to be impracticable to determine. 'Value in use' is defined as "the present value of the future cash flows expected to be obtained from an asset…" (see paragraphs 30 – 57 of that standard for the relevant guidance).

28. We cannot assess whether this is a simplification for preparers at this point with regard to this type of investments, but we believe the overall approach in IAS 36 is well-understood and due to the existence of a trigger approach in IAS 36 (see paragraphs 8-17 of that standard), an entity would be relieved from measuring any impairment on a recurring basis.

29. The staff wishes to highlight that IAS 36 requires reversals of impairment under some circumstances. This is a significant difference to the current cost exception in IAS 39 that prohibits reversals of impairment losses.

Impracticability not longer existent

30. There might be instances where it is no longer impracticable to determine fair value. In that case the guidance currently contained in IAS 39.53 could be carried forward that would require recognition of the difference between carrying amount and fair value in the current period.

31. The staff recommends carrying forward the guidance in IAS 39.53 in cases where it is no longer impracticable to determine fair value.

Disclosures

32. The staff believes that in cases an entity measures an unquoted equity instrument at cost it is necessary to highlight this fact to users and provide additional information. IFRS 7.30 already requires certain additional disclosures for unquoted equity instruments carried at cost to help users of financial statements make their own judgements about the extent of possible differences between the

carrying amount of those items and their fair value (the disclosures would be amended as necessary to reflect the change in guidance):

(a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;

(b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;

(c) information about the market for the instruments;

(d) information about whether and how the entity intends to dispose of the financial instruments; and

(e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

33. The staff thinks these disclosures are sufficient to mitigate the information deficiency resulting from cost measurement with regard to its predictive value.

34. The staff recommends carrying forward the disclosures required by IFRS 7.30 (amended as necessary).

Derivatives

35. Any measurement exemption could only be applied to **unquoted** equity instruments where it is impracticable to determine fair value. For **quoted** equity instruments fair value measurement is the appropriate measurement attribute in **all** circumstances.

36. It was not clear from the discussions at the 22 September meeting whether the Board wanted to extend the measurement exemption to **derivatives** over unquoted equity instruments.

37. The staff believes that if an entity enters into derivative transactions over unquoted equity instruments it should have sufficient information about the

underlying to value that derivative contract and hence an entity should be in a position to determine fair value.

38. **The staff recommends not extending a cost measurement exemption to derivatives over unquoted equity instruments.**

Questions to the Board
1. Does the Board agree with the cost measurement alternative for unquoted investments in equity instruments in cases where it is impracticable to determine fair value? If not, why and what does the Board wish to do, and why? 2. Does the Board agree that investments in unquoted equity instruments measured at cost should be subject to the impairment requirements in IAS 36? If not, why and what does the Board wish to do, and why? 3. Does the Board agree that all derivatives over unquoted equity instruments within the scope should be measured at fair value? If not, why and what does the Board wish to do, and why?

Appendix A

A1. If the Board wants to pursue a SINA approach this can be implemented in various ways:

(a) Use SINA both for initial measurement and subsequent measurement

(b) Use SINA only for subsequent measurement

(c) Use changes in SINA only for subsequent measurement

A2. **Alternative (a)** would be straightforward. The drawback of this is that current guidance uses a common measurement attribute on initial recognition – fair value. We would have to change that guidance to accommodate alternative (a). This alternative would also lead to recognition of day 1 gains or losses.

A3. **Alternative (b)** would not alter the measurement attribute for initial recognition. However as the measurement basis changes subsequently and the amount initially recognised is not used as a starting point, this alternative would inevitably lead to day 2 gains or losses.

A4. **Alternative (c)** would be similar to the equity method. The investment is recognised at fair value initially. Subsequently, the carrying amount is increased or decreased for changes in the SINA (adjusted if necessary).