Project **Fair Value Measurement**

Topic **Measuring the fair value of difficult to value assets and liabilities (including unquoted equity instruments)**

Purpose of this paper

1. In the deliberations leading to the issuance of IFRS 9 *Financial Instruments*, the IASB decided to:

   (a) remove the cost exception in IAS 39 *Financial Instruments: Recognition and Measurement* for unquoted equity instruments and some related derivatives

   (b) include a list of factors indicating that cost might and might not be an appropriate estimate of fair value; and to

   (c) discuss whether to include detailed guidance on how to measure the fair value of unquoted equity instruments in the fair value measurement project.

2. Although the IASB discussed this in the context of financial instruments, this paper focuses on all difficult to value assets and liabilities (including unquoted equity instruments). This is because the fair value measurement project addresses measurement of *all* assets and liabilities recognised at fair value.

3. This paper asks the boards whether to include in a converged fair value measurement standard:

   (a) additional guidance on how to measure the fair value of difficult to value assets and liabilities (including unquoted equity instruments)

(b) some indicators when cost might or might not be an appropriate estimate of fair value.[1]

4. If the boards agree to include the guidance in (b) in a converged fair value measurement standard, paragraphs 29-34 of this paper address where the guidance in (b) should reside. This paper assumes that if (a) or (b) is included in the fair value measurement standard, (b) will be removed from IFRS 9.

Summary of the guidance in IFRSs and US GAAP

5. The IASB's exposure draft *Fair Value Measurement* and the FASB's Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) provide general guidance about what to include in a fair value measurement, but do not address specifically the measurement of unquoted equity instruments.

6. IFRS 9 requires all equity instruments to be measured at fair value. It states that in limited circumstances, cost may be an appropriate estimate of fair value for unquoted equity instruments. It also includes indicators as to when cost might **not** be representative of fair value for unquoted equity instruments.

Background on the issuance of IFRS 9

7. The exposure draft preceding IFRS 9 proposed to measure all equity instruments held by an entity at fair value. IAS 39 contained a narrow exception for unquoted equity instruments and physically settled derivatives where such an instrument was the underlying if fair value cannot be reliably measured ('the cost exception').

8. Other respondents, particularly preparers, stated that the removal of the cost exemption would create complexity and cost for many entities, in particular if quarterly reports have to be published, as these types of holdings are very

[1] In IFRS 9, the 'cost' of a financial instrument carried at fair value through profit or loss excludes transaction costs. The 'cost' of an investment in an equity instrument carried at fair value through other comprehensive income includes transaction costs.

common in many parts of the world. Many respondents asked for additional guidance to value these unquoted equity instruments noting that many preparers do not have the expertise and/or experience to perform such valuations without the help of external experts (that further increases the cost of providing the information). Some respondents noted that up-to-date information is often unavailable on a timely basis, especially in emerging economies.

9. Although the IASB confirmed the proposal in the exposure draft (that is, to remove the cost exception), it decided to provide additional guidance about when cost might still be an appropriate estimate of fair value for unquoted equity instruments – and when it is not.

Summary of guidance in IFRS 9

10. The additional guidance in IFRS 9 describes when cost might be an appropriate estimate of fair value for unquoted equity instruments.

11. Paragraph B5.5 of IFRS 9 states that cost might be an appropriate estimate of fair value if:

    (a) there is insufficient recent information available to determine fair value at the measurement date or

    (b) there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

12. IFRS 9 states that cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

13. Paragraph B5.6 provides a non-exhaustive list of indicators that cost might **not** represent fair value:[2]

    (a) a significant change in the performance of the investee compared with budgets, plans or milestones.

[2] The IASB developed this guidance using the *International Private Equity and Venture Capital Valuation Guidelines* dated September 2009.

(b) changes in expectation that the investee's technical product milestones will be achieved.

(c) a significant change in the market for the investee's equity or its products or potential products.

(d) a significant change in the global economy or the economic environment in which the investee operates.

(e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.

(f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.

(g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

14. IFRS 9 requires that an entity must use all information about the performance and operations of the investee that becomes available after initial recognition and if any factors exist that suggest that cost does not represent fair value, an entity must estimate the fair value of the instrument.

Staff analysis and recommendation

15. This section addresses whether a converged fair value measurement standard should contain guidance:

(a) for measuring the fair value of difficult to value assets and liabilities (including unquoted equity instruments)

(b) about when cost might or might not be an appropriate estimate of fair value.

Should the fair value measurement standard contain specific guidance for measuring the fair value of difficult to value assets and liabilities (including unquoted equity instruments)?

16. The IASB's exposure draft and Topic 820 contain general information about what to include in, and how to perform, a fair value measurement. For example, they contain information about valuation techniques (eg descriptions of the market, income and cost approaches) and how to select inputs to valuation techniques (eg prioritise observable information over unobservable information).

17. The IASB's exposure draft and Topic 820 also state that the valuation is to be performed from the perspective of market participants. Therefore, a fair value measurement would include anything that market participants would consider in the pricing (and would not include anything that market participants would not consider). There is additional information about applying present value techniques (in the income approach) in an appendix to the IASB's exposure draft and Topic 820.

18. The fair value measurement standard assumes that those applying its concepts have some level of valuation knowledge, for example:

    (a) the ability to assess the 'value drivers' of an asset or liability and to determine which valuation technique or techniques are most appropriate in which circumstance, including knowledge of the strengths and limitations of each valuation technique

    (b) knowledge of how to source data that market participants would use as inputs to valuation techniques, to determine which data is most appropriate (and weigh accordingly) and to assess which sources are more reliable than others[3]

    (c) experience with applying judgement in a particular situation.

[3] By requiring fair value as a measurement basis for an asset or liability, the boards presume that such information is in fact available. See the next section for how the IASB has chosen to address circumstances in which such information is not available.

19. A standard that includes prescriptive requirements on how to measure the fair value of every asset or liability recognised at fair value would not be practical or principles-based. The converged fair value measurement standard would need to address the measurement of all assets and liabilities, including investment properties, machinery and equipment, customer relationships, collateralised debt obligations, interest rate swaps, biological assets, etc. The staff finds it difficult to justify providing explicit measurement guidance for unquoted equity instruments, but not for other difficult to value assets and liabilities.

20. **The staff recommends not to provide specific guidance for measuring the fair value of difficult to value assets and liabilities (including unquoted equity instruments) in a converged fair value measurement standard.**

21. The staff thinks the concerns of those unfamiliar with measuring the fair value of difficult to value assets and liabilities (including unquoted equity instruments) could be mitigated if the boards were to provide educational materials that accompany the fair value measurement standard. At a future meeting, the staff will ask the boards to consider whether to provide such educational materials.

Question 1 – Including specific guidance for measuring the fair value of difficult to value assets and liabilities
Do the boards agree with the staff recommendation not to provide guidance for measuring the fair value of difficult to value assets and liabilities (including unquoted equity instruments) in a converged fair value measurement standard? If not, would you like to provide guidance only for measuring unquoted equity instruments or for other assets and liabilities as well? What kind of guidance should we provide?

Should the fair value measurement standard contain guidance about when cost might be an appropriate estimate of fair value?

22. As stated above, IFRS 9 describes when cost might be an appropriate estimate of fair value for unquoted equity instruments.

23. IAS 16 *Property, Plant and Equipment* contains similar guidance. IAS 16 states that when the fair value of an asset remeasured at fair value under the revaluation model differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, requiring annual revaluations. Other items only need to be revalued every three or five years (see IAS 16.34). IAS 16 does not provide factors indicating when an asset has experienced 'significant and volatile changes in fair value'.

24. US GAAP does not contain similar guidance.

25. The staff thinks that this type of guidance is specific to the assets and liabilities in each particular standard and it would be difficult to develop specific guidance that is appropriate for all types of assets and liabilities.

26. Furthermore, including guidance on unquoted equity instruments in a converged fair value measurement standard would raise questions about why a similar approach is not being taken for other assets or liabilities to which the fair value measurement guidance applies

27. **The staff recommends not to include guidance about when cost might be an appropriate estimate of fair value in a converged fair value measurement standard. For the IASB, this would mean that such guidance will be retained in their respective standards (eg IFRS 9 and IAS 16).**

Question 2 – Including guidance about when cost might be an appropriate estimate of fair value
Do the boards agree with the staff recommendation not to include guidance about when cost might be an appropriate estimate of fair value in a converged fair value measurement standard? If the boards disagree, should such guidance pertain only to *unquoted equity instruments* or to *all assets and liabilities* measured at fair value?

28. If the boards disagree with the staff recommendation, please continue to the next section.

<u>THIS SECTION IS RELEVANT ONLY IF THE BOARDS DO NOT AGREE WITH THE STAFF RECOMMENDATION IN QUESTION 2</u>

Where should a converged fair value measurement standard provide guidance about when cost might be an appropriate estimate of fair value reside?

29. If the boards do not agree with the staff recommendation in paragraph 27 of this paper (ie to include guidance about when cost might be an appropriate estimate of fair value in a converged fair value measurement standard), there are three options for integrating such guidance into a converged fair value measurement standard:

    (a) **Option 1**: add it to the main body of the standard (mandatory guidance)

    (b) **Option 2**: add it to the application guidance of the standard (mandatory guidance)

    (c) **Option 3**: add it to the illustrative examples of the standard (non-mandatory guidance for the IASB, mandatory guidance for the FASB).

30. For the body of the fair value measurement standard itself to include a general principle about what to do when fair value is difficult to determine seems inappropriate. It seems that such guidance should be in either the application guidance or illustrative examples.

31. Including such guidance in the illustrative examples section raises the following issue:

    (a) in IFRSs, illustrative examples are **not** part of the mandatory guidance, but

    (b) in US GAAP, illustrative guidance **is** part of the mandatory guidance.

32. The staff thinks this would create a GAAP difference that is neither necessary nor desirable.

33. Including such guidance in the application guidance seems to be the best option because:

(a) as mandatory guidance, it would ensure that there is no change in practice (eg the relevant guidance in IFRS 9 and IAS 16 are part of the mandatory guidance)

(b) there would not be a GAAP difference.

34. **If the boards wish to provide guidance about when cost might be an appropriate estimate of fair value, the staff recommends including that guidance in the (mandatory) application guidance of a converged fair value measurement standard.**

Question 3 – Where to include guidance about when cost might be an appropriate estimate of fair value
If the board wish to provide guidance about when cost might be an appropriate estimate of fair value, do the boards agree with the staff recommendation to include it in the (mandatory) application guidance of a converged fair value measurement standard? If not, what do you propose and why?