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Project	**Fair Value Measurement**		
Paper topic	Portfolio exception		
CONTACT	Mariela Isern	misern@ifrs.org	+44 (0)20 7246 6483

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Introduction

1. In October 2012, the IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the unit of account for financial assets that are investments in a subsidiary, joint venture or associate. A similar request was also received by the IASB in December 2012.[1] The submission to the Interpretations Committee also requested clarification on the interaction between the use of Level 1 inputs and the unit of account when applying the portfolio exception set out in IFRS 13 *Fair Value Measurement* (the submission is reproduced in full in Appendix 1 to this paper).

2. The question regarding the unit of account for investments in subsidiaries, joint ventures and associates was discussed by the IASB at its February and March 2013 meetings. The IASB tentatively decided that the **unit of account** is the **investment as a whole** rather than the individual financial instruments that make up the investment.

3. The interaction between the use of Level 1 inputs and the unit of account in the case of investments in subsidiaries, joint ventures, associates, and in case of a cash-generating unit (CGU) that corresponds to a quoted entity, was discussed at

[1] See Appendix 2 of Agenda Paper 5 and Appendix 2 of Agenda Paper 4 discussed at the IASB meetings in February and March 2013, respectively, which can be found at: http://www.ifrs.org/Meetings/Pages/IASBFebruary2013.aspx and http://www.ifrs.org/Meetings/MeetingDocs/IASB/2013/March/04-Fair-Value-Measurement.pdf.

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the IASB meetings in February, March and May 2013.[1, 2] The IASB tentatively decided that the fair value measurement of an investment composed of quoted financial instruments should be the product of the quoted price of the financial instruments (P) multiplied by the quantity (Q) of instruments held (ie P × Q). In the same way, the IASB also tentatively decided that the fair value measurement of cash-generating units (CGUs) for impairment testing when those CGUs correspond to a quoted entity should be the product of their quoted price (P) multiplied by the quantity (Q) of instruments held (ie P × Q).

4. The issue concerning the interaction between the unit of account and the use of Level 1 prices when applying the portfolio exception as set out in IFRS 13 was discussed by the Interpretations Committee in May 2013.[3] On the basis of the information presented, the Interpretations Committee was not able to answer the issue submitted. It decided that this matter should be considered by the IASB.[4]

5. The staff informed the IASB about the Interpretations Committee's recommendation in May 2013. The IASB noted that the portfolio exception issue had similarities with the issue of the interaction between the use of Level 1 inputs and the unit of account that arises when measuring the fair value of investments in subsidiaries, joint ventures and associates. Consequently, the IASB tentatively decided to consider the portfolio exception issue before finalising the Exposure Draft that clarifies the fair value measurement of quoted investments in subsidiaries, joint ventures and associates.

6. This paper addresses the above mentioned portfolio exception issue.

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[2] The Agenda Paper discussed at the IASB meeting in May can be found at: http://www.ifrs.org/Meetings/Pages/IASBMay2013.aspx

[3] The Agenda Paper discussed at the IFRS IC meeting in May can be found at: http://www.ifrs.org/Meetings/meetingDocs/Interpretations%20Committee/2013/May/AP18%20Fair%20Value%20Measurement.pdf

[4] The Interpretations Committee Update is included in Appendix 3 to this paper.

Purpose and structure of this paper

7. The objective of this paper is to analyse the issue submitted about the portfolio exception in IFRS 13.

8. The portfolio exception is an **accounting policy choice** that enables an entity to measure its net exposure to market risks, or to credit risk arising from a group of financial assets and financial liabilities that are measured at fair value subject to satisfying certain criteria (see paragraphs 48–52 of IFRS 13 reproduced in Appendix 2 to this paper).

9. Figure 1 illustrates the issue submitted. As per the the submission, there are currently different views (which are analysed in this paper) concerning the application of the portfolio exception when dealing with financial instruments that have a Level 1 price:

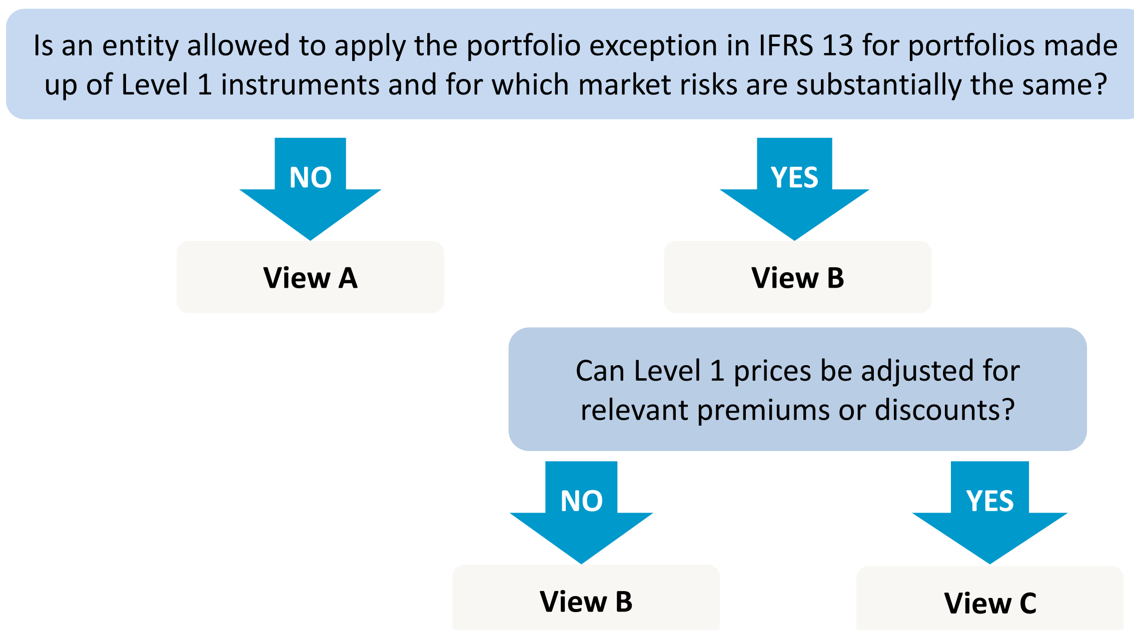

Figure 1—Issue submitted

10. The structure of this paper is as follows:

    (a) background information about the portfolio exception (paragraphs 11–13);

    (b) description of the issue submitted (paragraphs 14–16);

    (c) staff's analysis and recommendation (paragraphs 17–28); and

    (d) next steps (paragraphs 29–33).

Background information—the portfolio exception

11. During the development of IFRS 13 and the amendments to Topic 820 *Fair Value Measurement* in the FASB Accounting Standards Codification®, the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), discussed the fair value measurement of financial instruments within a portfolio at their joint meeting in March 2010.[5] At that meeting the IASB and the FASB (the boards) decided to permit entities, in specific circumstances (see paragraph 12), to measure their net exposure to either market risks or credit risk arising from a group of financial assets and financial liabilities.

12. An entity must meet the following conditions to be able to use the portfolio exception (see paragraph 49 of IFRS 13):

    (a) it must manage the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with its documented risk management or investment strategy;

    (b) it must provide information on that basis about the group of financial assets and financial liabilities to the its key management personnel; and

    (c) it is required or has elected to measure those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.

13. The portfolio exception does not pertain to financial statement presentation (see paragraph 50 of IFRS 13).

[5] This topic was discussed at the joint meeting in March 2010 (see IASB Agenda Paper 3/FASB Agenda Paper 5 at: http://www.ifrs.org/Meetings/MeetingDocs/IASB/2010/March/11th/FVM-110310-AP3-obs.pdf).

The issue

14. As illustrated in Figure 1, the question that has been raised is as follows:

    (a) whether the portfolio exception can be applied to a portfolio fully made up of Level 1 financial instruments for which market risks are substantially the same;[6] and, if so,

    (b) whether the Level 1 prices can be adjusted for any relevant premiums or discounts (ie whether the net risk exposure should be measured using only unadjusted Level 1 prices or whether the net risk exposure can be measured by considering any potential adjustments to the Level 1 prices).[7]

15. The above question has been analysed using an example, based on the submission, which is given below.

Example

Entity A has a long position of 10,000 individual financial assets and a short position of 9,500 individual financial liabilities for which market risks are substantially the same.

All financial instruments are categorised as **Level 1** of the fair value hierarchy.

Bid, ask prices and the most representative exit price within the bid-ask spread are as follows:

	Bid	**Mid**	**Ask**
Prices (in CU)[8]	98	100	102
Most representative exit price[9]	99		101

[6] Guidance relating to risks that are substantially the same can be found in paragraphs 54 and 55 of IFRS 13.

[7] IFRS 13 defines Level 1 inputs as ‘quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.’

[8] In this example, and in all other examples or tables in this paper, monetary amounts are denominated in ‘currency units (CU)’.

[9] Paragraph 70 of IFRS 13 states that ‘if an asset or a liability […] has a bid price and an ask price […], the price within the bid-ask spread that is the most representative of fair value […] shall be used […].’.

16. The submission states that there are different views on how the portfolio above could be measured if an entity applies the portfolio exception. All views share the assumption that for purposes of presentation the instruments are shown gross in the statement of financial position:

(a) **View A** (*Views 2 and 3 of the submission*). The portfolio exception cannot be applied to portfolios of Level 1 financial instruments (ie the portfolio exception is designed only for portfolios containing financial assets and financial liabilities that are categorised within Level 2 or Level 3). This is because the existence of Level 1 prices takes precedence as a matter of principle and as a matter of reliability. Taking this view, Entity A measures each financial asset and each financial liability individually based on its corresponding Level 1 prices (see Table 1).

Table 1 — Measurement under View A			
	Quantity held (Q)	**Most representative quoted market price (CU) (P)**	**(CU) P x Q**
Financial assets	10,000	99	990,000
Financial liabilities	-9,500	101	-959,500
			30,500

(b) **View B**. IFRS 13 does not restrict the portfolio exception to portfolios that contain solely financial assets and financial liabilities that would be categorised within Levels 2 or 3. Taking this view, Entity A would apply the portfolio exception and would measure the net long position in accordance with the corresponding Level 1 prices, but the presentation would be gross (see Table 2). The **same results** would be achieved by measuring the instruments at mid price and adjusting them for a bid-offer reserve.

Table 2 — Measurement under View B			
	Quantity held (Q)	**Quoted market price (CU) (P)**	**(CU) P x Q**
Financial assets	10,000	99	990,000
Financial liabilities	-9,500	99	-940,500
Net long position	**500**	**99**	**49,500**

(c) **View C** (*Views 1 and 4 of the submission*). The unit of measurement is the net risk exposure (ie the portion of the market risk that has not been offset) for which there are no Level 1 inputs available. As a result, because there are no direct inputs for that unit of measurement, the fair value of the net risk exposure should be measured by applying a valuation technique that considers its characteristics. In other words, the measurement can be based on the Level 1 prices of the underlying individual financial instruments that the net risk exposure includes, but it can then be further adjusted for premiums or discounts if those are believed to be features of the characteristics of the unit of measurement. In addition, when the fair value measurement based on the net risk exposure maximises value to the entity, this would reinforce the fact that an entity would be allowed to apply the portfolio exception in the manner described above. Consequently, using View C, Entity A concludes that the most representative exit price for a net long position of 500 financial assets (ie 10,000 financial assets minus 9,500 financial liabilities) is CU45,000 (see paragraph below).

Table 3 illustrates the measurement using this view. In this case, Entity A has concluded that the net risk exposure (CU49,500) should be further adjusted by CU4,500 to reflect a discount for size. The net valuation would equate to the 500 financial assets (CU49,500) adjusted by the discount for size of CU4,500 (ie CU45,000). For the purposes of the example, the adjustment (CU4,500) has been allocated in column (B) proportionally to the financial assets and financial liabilities comprising the portfolio (the example assumes that such an allocation methodology meets the requirements in paragraph 50 of IFRS 13).

Table 3 — Measurement under View C

			(A)	(B)	(A) + (B)
	Quantity held (Q)	**Quoted market price (CU) (P)**	**(CU) P x Q**	**Adjustment**	**Final amounts**
Financial assets	10,000	99	990,000	-90,000	900,000
Financial liabilities	-9,500	99	-940,500	85,500	-855,000
Net long position	**500**	**99**	**49,500**	**-4,500**	**45,000**

Staff's analysis and recommendation

17. According to paragraph BC117 of IFRS 13 one of the primary reasons for introducing the portfolio exception was to align the valuation of financial instruments for financial reporting to an entity's internal risk management practices.

18. In addition the IASB brought in the portfolio exception for the following reasons:

    (a) Entities generally do not manage their exposure to market and credit risks arising from financial instruments on the basis of each individual contract. Instead risk exposures are managed on a portfolio basis. In addition such exposures are managed not by either selling a financial asset or by transferring a financial liability but are managed by entering into offsetting risk positions through other instruments (see paragraph BC117 (a) of IFRS 13). This is especially true of derivative instruments. Consequently, the exception allows entities to measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price such net risk exposures.

    (b) For practical reasons. Modelling the long positions to the bid prices and short positions to the ask prices requires the use of two interest rate curves, exchange rate curves, etc. In contrast, permitting entities to measure the net risk exposure rather than the individual instruments allows entities to use inputs based on mid prices irrespective of the direction of the position. This is important when an entity has thousands of financial instruments to measure.

    (c) Having a consistent valuation basis for all financial instruments means that entities can identify the natural offsets and manage their risk in a manner that maximises value to the entity.

    (d) To avoid systems modifications. Requiring entities to mark each long position to the bid price and each short position to the ask price would have required significant systems modifications at significant cost, because it would be inconsistent with risk management (see paragraph BC115 of IFRS 13).

(e) Last but not least to maintain existing practice under IAS 39 *Financial Instruments: Recognition and Measurement* (see paragraph BC110 of IFRS 13).

19. Consequently, the staff are of the view that the intention of the IASB was **not** to restrict the application of the portfolio exception in IFRS 13 to portfolios exclusively made up of Level 2 or/and Level 3 financial instruments.

20. However, the staff are also of the view that the intention of the IASB was not to override the fundamental principles in IFRS 13 through this exception which are as follows:

(a) maximising the use of observable inputs and minimising the use of unobservable inputs (see paragraph 61 of IFRS 13);

(b) using Level 1 inputs without adjustment whenever they are available (see paragraphs 69, 77 and 80 of IFRS 13);[10]

(c) not applying blockage factors (see paragraphs 69 and 80 of IFRS 13); and

(d) using market participants' assumptions (see paragraph 22 of IFRS 13).

21. In addressing the issue submitted (ie how an entity applies the portfolio exception for a portfolio that is fully made up of Level 1 instruments), the staff believe that the issue is limited to answering what the appropriate price (P) is and what the appropriate quantity (Q) is to be considered in the measurement.

22. In relation to P, the staff believe that **Level 1 prices** are the prices to be considered, because of the following principles:

(a) maximise the use of observable inputs and minimising the use of unobservable inputs (see paragraph 61 of IFRS 13); and

(b) use Level 1 inputs without adjustment whenever they are available (see paragraphs 69, 77 and 80 of IFRS 13).

[10] The paragraphs relating to the portfolio exception in IFRS 13 and paragraphs 69, 77 and 80 of IFRS 13 are reproduced in Appendix 2 to this paper.

23. In relation to Q, the staff believe that the quantity reflected by **the net long position** (ie 500 financial assets, in our case) is the appropriate Q because:

    (a) the market risks of the financial instruments are substantially the same and, as result, they can be offset; and

    (b) the net long position of 500 financial assets reflects how Entity A would exit or close out such outstanding risk exposure.

24. The following factors additionally provide support for View B:

    (a) View B represents a continuity with practice under IAS 39 and IFRS 9 *Financial Instruments*, which the IASB did not intend to change by issuing IFRS 13 (see paragraph 25);

    (b) IFRS 13 does not permit the use of blockage factors. As a result, View C would be discarded as a possible measurement option (see paragraph 26); and

    (c) View B maximises value for the entity (see paragraph 27).

25. As mentioned above, View B provides continuity with practice under IAS 39 and IFRS 9. IAS 39 and IFRS 9 permit an entity to take into account the effects of offsetting positions within the same market risk (or risks) when measuring the fair value of a financial asset or financial liability, which was also extended to credit risk by analogy by some entities.[11, 12] Paragraph AG72 of IAS 39 is reproduced below [emphasis added]:[13]

> AG72 The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. **When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate.** When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been

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[11] See paragraph BC110 of IFRS 13.

[12] A difference in measurement under IAS 39 and View B could only arise if there was a difference between the bid price for the net long position and the price within the bid-ask spread that is the most representative of fair value. This is because IAS 39 requires the use of the bid price for the net long position, while under IFRS 13 one would consider the price within the bid-ask spread that is the most representative of fair value (ie the most representative price to exit a particular net risk exposure).

[13] Paragraph AG72 of IAS 39 is identical to paragraph B5.4.4 of IFRS 9. References to paragraph AG72 of IAS 39 in this paper should be read as being also applicable to paragraph B5.4.4 of IFRS 9.

> a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (eg a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (eg because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

26. View C considers that the unit of measurement is the net risk exposure for which there are no relevant Level 1 inputs (ie the Level 1 prices are relevant inputs for the individual financial instruments, but not for the net risk exposure). As a result, taking this view an entity would include in its measurement any premiums and discounts that it believes are relevant to the fair value measurement of the net risk exposure. However, as mentioned above, the Standard states that Level 1 inputs should be used without adjustment whenever they are available and it does not permit the use of blockage factors (paragraphs 69, 77 and 80 of IFRS 13).

27. When comparing the resulting measurements from View A and View B (note that View C is not considered for this comparison as it is based on the use of blockage factors, which are not permitted by the Standard), the measurement resulting from View B is the one that maximises value for Entity A.

28. The measurement using View B prioritises the use of Level 1 inputs for the financial instruments that underlie Entity A's net risk position. This is consistent with requirements in IFRS 13. The staff believe that the appropriate measurement if an entity opts[14] to use the portfolio exception for a portfolio made up only of Level 1 instruments, for which market risks are substantially the same is the one resulting from View B.

[14] The portfolio exception is an accounting policy choice and consequently an entity may not opt to apply the portfolio exception and thus measure the portfolio on a gross valuation basis (ie View A).

Question for the IASB

Question 1 — Staff's analysis and recommendation
Does the IASB agree with the staff's analysis and recommendation outlined in paragraphs 17–28 of this Agenda Paper?

Next steps

29. If the IASB agrees with the staff's recommendation then this section of the paper considers whether there is a need for any clarification or amendment to IFRS 13.

30. The staff think that when an entity elects to apply the portfolio exception for a portfolio fully made up of Level 1 instruments whose market risks are substantially the same, View B results from the direct application of the measurement principles in IFRS 13:

    (a) Level 1 prices should be used without adjustment whenever they are available;

    (b) blockage factors are not permitted; and

    (c) the measurement resulting from View B represents how market participants would price the net risk exposure resulting from a portfolio fully made up of Level 1 financial instruments whose risks are substantially the same.

31. As a result, we do not think that any amendments to IFRS 13 are needed to clarify the application of the portfolio exception for the particular case submitted.

32. However, because the submission reflects the existence of different views, we believe that including an example in the Standard would be useful to illustrate the use of the principles in the Standard when an entity elects to apply the portfolio exception for a portfolio fully made up of Level 1 instruments whose market risks are substantially the same.

33. The staff think that such an example could be included in the same Exposure Draft that clarifies the fair value measurement of quoted investments in subsidiaries, joint ventures and associates. Even though the nature of the

illustrative example would be non-authoritative, including it in the Exposure Draft would give respondents an opportunity to comment.

Question for the IASB

Question 2 — Next steps
Does the IASB agree with the staff's recommendation to include a non-authoritative illustrative example to illustrate the issue submitted in relation to the portfolio exception in the same Exposure Draft that clarifies the fair value measurement of quoted investments in subsidiaries, joint ventures and associates?

APPENDIX 1

IFRIC potential agenda item request

This letter describes two related issues that we believe should be added to the IFRIC's agenda. We have included a summary of the issues, a range of possible views and an assessment of the issues against the IFRIC's agenda criteria.

There is currently no established practice because IFRS 13 *Fair Value Measurement* is not yet in effect. However, we believe that these issues are likely to establish themselves as practice issues once entities begin to apply the standard. We believe that the IFRIC should consider the issues because the potential outcomes could have a significant effect on the measurement of fair value, and consistency in this area is desirable.

Issue 1: The unit of account for financial assets that are investments in a subsidiary, joint venture or associate and related retained or pre-existing interests

IFRS 13 explicitly introduces the concept of the 'unit of account', which is determined in accordance with the relevant IFRS that requires or permits the fair value measurement. In many cases the unit of account can be inferred, e.g. a cash-generating unit in IAS 36 *Impairment of Assets*; however, for a financial asset that is an investment in a subsidiary, joint venture or associate it is not clear because the investment held by the entity comprises a number of individual shares.

The following are examples:

1. An investment in a subsidiary, joint venture or associate accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* / IFRS 9 *Financial Instruments* in separate financial statements. [IAS 27.10(b)]
2. An investment in a joint venture or associate accounted for in accordance with IAS 39 / IFRS 9 by a venture capital or similar organisation. [IAS 28.18]
3. An investment in a subsidiary, joint venture or associate measured at fair value in accordance with IAS 39 / IFRS 9 by an investment entity. [Forthcoming amendment to IFRS 10 and IAS 28]
4. Shares in a subsidiary, joint venture or associate distributed to owners. [IFRC 17.11]
5. A previously held equity interest in an acquiree in accounting for a business combination achieved in stages. [IFRS 3.42]
6. A retained interest following a loss of control, joint control or significant influence. [IFRS 10.25(b), IAS 28.22(b)]

For all of the above items, the issue is whether the unit of account is an individual share or the entire holding. This interpretation makes a difference in applying IFRS 13. For example, if the unit of account is an individual share, then there is no possibility of arguing, for example, that a premium related to the size of the holding should be included in the measurement of fair value.

The following are the different approaches that we believe an entity could take once IFRS 13 becomes effective.

View 1: Unit of account is the entire investment

Notwithstanding that the investment comprises a number of individual shares, the unit of account is the investment as a whole. This is on the basis that the accounting in the underlying IFRS (or Interpretation) is premised on the item as a whole, and not on it being a collection of smaller items.

View 2: Unit of account is the individual share

For financial assets, even if outside the scope of IAS 39 / IFRS 9, the unit of account is the individual share, which is consistent with the approach generally taken under IAS 39 / IFRS 9. This is consistent with IFRS 13.BC47, which states that the unit of account under IAS 39 / IFRS 9 is generally an individual financial instrument.

View 3: Mixed approach depending on the financial asset

Views 1 and 2 represent the two extremes, but in between there are more nuanced approaches that seek to distinguish between the types of investments / references within the standards. The following are two examples of which we are aware:

- *Investments in subsidiaries, joint ventures and associates vs 'other items'*

  Under this approach, the unit of account for investments in subsidiaries, joint ventures and associates is the entire investment. While the investment comprises a number of individual shares and therefore it might be argued that the unit of account should be the same as if the general approach under IAS 39 / IFRS 9 is applied, the accounting models for such investments acknowledge that control, joint control and significant influence have a special significance and that the accounting relates to the investment (relationship) as a whole.

  However, investments that do not confer control, joint control or significant influence are no different from other financial assets within the scope of IAS 39 / IFRS 9, and therefore the unit of account should be the individual share.

- *Investments whose accounting is 'in accordance with' IAS 39 or IFRS 9 vs 'other items'*

  Under this approach, the unit of account for the investment is the individual share when the relevant IFRS specifically refers to accounting 'in accordance with' IAS 39 / IFRS 9, or when IAS 39 / IFRS 9 applies subsequently. This would apply to the first three examples raised at the start of this letter, plus the sixth example (loss of control) in many cases.

  In all other cases, the unit of account would be the entire investment.

Issue 2: Interaction between guidance on use of Level 1 inputs and the unit of account

Having established the unit of account, it is then necessary to determine the 'unit of valuation'. Although this term is not defined in IFRS, it is used in this letter to indicate the level at which an asset or a liability is aggregated or disaggregated for the purpose of measuring fair value.

As a general principle, the unit of valuation is based on the unit of account for the asset or liability determined in accordance with the IFRS that requires or permits the fair value measurement, subject to the exceptions in IFRS 13, e.g. in paragraph 48. However, the standard is

unclear on the interaction between the unit of account/valuation guidance in paragraph 14 and the requirement to use unadjusted Level 1 prices, when available, in paragraphs 69, 77 and 80.

Possible approaches

The following are the different approaches that we believe an entity could take once IFRS 13 becomes effective.

View 1: Level 1 price required only if available for the unit of account

A Level 1 price is applied without adjustment only if it exists for the unit of valuation established under the relevant IFRS that requires or permits the fair value measurement or by another requirement in IFRS 13. If that unit of valuation is an aggregation of assets or liabilities and a Level 1 price is unavailable at that level, then it is not required that the Level 1 price for an individual asset or liability be used without adjustment to value the aggregate holding.

View 2: Level 1 price takes precedence as a matter of principle

Even if the unit of valuation would otherwise be an aggregate holding, the fair value of an aggregate position that comprises items that are quoted in an active market to which the entity has access at the measurement date must be measured as the product of the Level 1 price for the individual item and the quantity held by the entity.

View 3: Level 1 price takes precedence as a matter of reliability

The guidance on Level 1 inputs that is provided in IFRS 13.77 requires an entity to use, if available, a quoted price in an active market because it provides the most reliable evidence of fair value. Therefore, based on its observability, a Level 1 price for constituent assets and / or liabilities takes precedence over a Level 2 or Level 3 price for the unit of valuation.

Although Views 2 and 3 are different, they both result in a fair value measurement for an aggregated position based on the price of an individual constituent asset or liability times the number of assets or liabilities held.

Examples

The following examples illustrate the effect of the above views.

Cash-generating unit that corresponds to a listed entity

The unit of account for impairment testing under IAS 36 is not an individual share but the cash-generating unit (CGU) as a whole comprising its underlying operating assets and liabilities.

Under View 1, because a price is not available in an active market for the whole CGU, neither IFRS 13.69 nor 80 apply. Accordingly, if a market participant would include a premium for control in valuing the CGU, then the fair value of the CGU includes a control premium. Although the Level 1 price for an individual share would be a very important input in determining fair value, it would not necessarily be determinative in valuing the CGU as a whole.

The following are additional arguments in favour of this view for a CGU:

- IFRS 13.69 specifically discusses the application of a control premium to value a controlling interest. The ability to consider a control premium to measure the fair value of a holding in a CGU whose shares are not publicly traded, but not when a CGU's shares are publicly traded, would result in the inconsistent treatment of similar interests.
- If an entity paid a premium to acquire control of a CGU but was subsequently required to measure the CGU using a share price that excluded a control premium, impairment could result, even if there had been no underlying decline in the economic value of the CGU.
- US GAAP allows the inclusion of a control premium when valuing a reporting unit for impairment testing, even when a Level 1 price for the underlying shares is available.[15]
- The carrying amount of a CGU is generally based on operating assets and liabilities and excludes items such as financing items. However, a share price will reflect all of the assets and liabilities of the legal entity that issued the shares, including non-operating assets and liabilities. Therefore, an issue is practice may be whether the market capitalisation based on the share price is a like-for-like comparison with the items included in the carrying amount of the CGU.

Under View 2, the unit of valuation differs from the unit of account through the application of IFRS 13.69 and 80, and is an individual share because a Level 1 price is available at that level. Therefore, no control premium would be considered in valuing the CGU, even if market participants would consider such a premium in valuing a controlling stake in the CGU; this is because a control premium does not attach to an individual share.

Under View 3, the unit of valuation is the CGU, consistent with the general principles in IFRS 13.13-14. However, the Level 1 price is seen as the most reliable measure of fair value to be used in all circumstances. Under this view, the fair value of the CGU would be determined as the Level 1 price times the quantity held as this will provide the most verifiable evidence of fair value.

The logic of the three views outlined above applies equally to other examples, such as the fair value of an investment in a subsidiary, joint venture or associate when the unit of account is the entire investment (see Issue 1).

[15] ASC paragraphs 350-20-35-22 through 35-24

Portfolio exception for financial assets and financial liabilities

The unit of account for financial assets and financial liabilities subject to the portfolio exception is the individual financial instrument in accordance with IAS 39 / IFRS 9.

Under View 1, the unit of valuation is the net risk exposure in accordance with IFRS 13.48. A Level 1 input for an individual financial instrument is not a Level 1 input for the net risk exposure; therefore, neither IFRS 13.69 nor 77 apply. Consequently, it is irrelevant whether there is a Level 1 input available for an individual financial instrument as the fair value measurement should be based on the characteristics of the net risk exposure. This leads to consistent application of the portfolio exception regardless of the categorisation of the constituent financial assets' or financial liabilities' fair value measurements in the fair value hierarchy. This is consistent with the fact that IFRS 13 does not restrict the portfolio exception only to portfolios that contain solely financial assets and financial liabilities that would be categorised within Levels 2 or 3.

Under Views 2 and 3, the portfolio exception cannot be applied to portfolios containing financial assets and financial liabilities for which a Level 1 price exists. The portfolio exception is designed for portfolios containing financial assets and financial liabilities that are categorised within Levels 2 or 3 of the fair value hierarchy. The restrictions on the adjustment of Level 1 inputs prohibit application of the portfolio exception to portfolios that contain financial assets and financial liabilities for which a Level 1 input exists. Application of the portfolio exception would lead in this case to measurements that are not in accordance with IFRS 13. For example, any portfolio level adjustment based on a portfolio containing financial assets and financial liabilities for which a Level 1 price is available implies an adjustment of the quoted price for these individual assets and liabilities, regardless of the methodology for allocating the portfolio level adjustments. This would be inconsistent with IFRS 13.69, 77 and 80. Alternatively, allocation of the total portfolio level adjustment to only the individual financial assets and financial liabilities that are categorised in Level 2 or 3 leads to measurement of these financial assets and financial liabilities in a manner that is not representative of their respective exit prices.

Under an additional View 4 that is relevant in relation to the portfolio exception, the portfolio exception could be applied only if it maximises value. It is expected that entities that qualify for the portfolio measurement exception would choose to apply the portfolio exception because management of the net risk exposure maximises value to the entity. This is in line with IFRS 13.22, which explains that a fair value measurement is based on assumptions used by market participants, who act in their economic best interest. In addition, as stated in IFRS 13.BC67, a fair value measurement assumes that market participants seek to maximise the fair value of a financial asset or to minimise the fair value of a financial

liability and such a transaction might involve grouping assets and liabilities in a way in which market participants would enter into a transaction, if the unit of account in other IFRSs does not prohibit that grouping. Accordingly, the portfolio exception may not be applied so as to change the unit of valuation in a manner that leads to less favourable fair value measurements than arise from valuing the individual financial instruments within the portfolio on a stand-alone basis. The guidance in IFRS 13.69, 77 and 80 generally requires the use of unadjusted Level 1 inputs for the individual constituent financial assets and financial liabilities for which Level 1 inputs are available. This guidance on Level 1 inputs precludes an application of the portfolio exception that results in less favourable fair value measurements than without its application.

For example assume the following fact pattern:

- Long position of 10,000 individual financial assets and short position of 9,500 individual financial liabilities in a particular market risk.
- Bid price is CU 98; mid price is CU 100; ask price is CU 102.
- The most representative exit price within the bid-ask spread of an individual financial asset is CU 99, and of an individual financial liability is CU 101.
- The most representative exit price for a net position of 500 financial assets is CU 45,000.
- All financial assets and financial liabilities are categorised in Level 1 of the fair value hierarchy.

Without application of the portfolio exception, the fair value measurements of the financial assets and financial liabilities would be based on their individual fair values. As such, a fair value measurement of the portfolio would be CU 30,500 (CU 10,000 × CU 99 - CU 9,500 × CU 101). In this example, a fair value measurement based on the net risk exposure amounting to CU 45,000 maximises value to the entity. Under View 4, the fair value measurement of the group of financial assets and financial liabilities is based on the fair value of the net risk exposure, although the fair value measurement cannot be lower than the fair value using the Level 1 inputs of the constituent financial assets and financial liabilities amounting to CU 30,500. Therefore, based on View 4, in this specific fact pattern an entity would be allowed to apply the portfolio exception to value the net risk exposure as a single item.

Reasons for the IFRIC to address the issue

a) ***Is the issue widespread and practical?*** Yes. The determination of fair value is integral to the application of IFRS.

b) ***Does the issue involve significantly divergent interpretations?*** Yes. Depending on the interpretation applied, the different approaches to the measurement of fair value (e.g.

whether to include a control premium) could have a significant effect on an entity's financial position and financial performance.

c) ***Would financial reporting be improved through elimination of the diversity?*** Yes. The comparability of financial statements will be improved if entities determine fair value on the same basis.

d) ***Is the issue sufficiently narrow…?*** Yes. Regarding Issue 1, we believe that the issue is capable of interpretation within the confines of IFRS 13 to the extent that standards are already issued; in the future, the issue can be dealt with by the Board in the context of each new standard or amendment. Regarding Issue 2, we believe that the issue is capable of interpretation within the confines of IFRS 13. Both issues related to specific concepts introduced by IFRS 13.

e) ***If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*** The issue does not relate to a current or planned IASB project.

APPENDIX 2—Relevant paragraphs of IFRS 13 *Fair Value Measurement*

Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk

48 An entity that holds a group of financial assets and financial liabilities is exposed to market risks (as defined in IFRS 7) and to the credit risk (as defined in IFRS 7) of each of the counterparties. If the entity manages that group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the entity is permitted to apply an exception to this IFRS for measuring fair value. That exception permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (ie an asset) for a particular risk exposure or to transfer a net short position (ie a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions. Accordingly, an entity shall measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date.

49 An entity is permitted to use the exception in paragraph 48 only if the entity does all the following:

(a) manages the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the entity's documented risk management or investment strategy;

(b) provides information on that basis about the group of financial assets and financial liabilities to the entity's key management personnel, as defined in IAS 24 *Related Party Disclosures*; and

(c) is required or has elected to measure those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.

50 The exception in paragraph 48 does not pertain to financial statement presentation. In some cases the basis for the presentation of financial instruments in the statement of financial position differs from the basis for the measurement of financial instruments, for example, if an IFRS does not require or permit financial instruments to be presented on a net basis. In such cases an entity may need to allocate the portfolio-level adjustments (see paragraphs 53–56) to the individual assets or liabilities that make up the group of financial assets and financial liabilities managed on the basis of the entity's net risk exposure. An entity shall perform such allocations on a reasonable and consistent basis using a methodology appropriate in the circumstances.

51 An entity shall make an accounting policy decision in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to use the exception in paragraph 48. An entity that uses the exception shall apply that accounting policy,

including its policy for allocating bid-ask adjustments (see paragraphs 53–55) and credit adjustments (see paragraph 56), if applicable, consistently from period to period for a particular portfolio.

52 The exception in paragraph 48 applies only to financial assets and financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*.

Exposure to market risks

53 When using the exception in paragraph 48 to measure the fair value of a group of financial assets and financial liabilities managed on the basis of the entity's net exposure to a particular market risk (or risks), the entity shall apply the price within the bid-ask spread that is most representative of fair value in the circumstances to the entity's net exposure to those market risks (see paragraphs 70 and 71).

54 When using the exception in paragraph 48, an entity shall ensure that the market risk (or risks) to which the entity is exposed within that group of financial assets and financial liabilities is substantially the same. For example, an entity would not combine the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability because doing so would not mitigate the entity's exposure to interest rate risk or commodity price risk. When using the exception in paragraph 48, any basis risk resulting from the market risk parameters not being identical shall be taken into account in the fair value measurement of the financial assets and financial liabilities within the group.

55 Similarly, the duration of the entity's exposure to a particular market risk (or risks) arising from the financial assets and financial liabilities shall be substantially the same. For example, an entity that uses a 12-month futures contract against the cash flows associated with 12 months' worth of interest rate risk exposure on a five-year financial instrument within a group made up of only those financial assets and financial liabilities measures the fair value of the exposure to 12-month interest rate risk on a net basis and the remaining interest rate risk exposure (ie years 2–5) on a gross basis.

Exposure to the credit risk of a particular counterparty

56 When using the exception in paragraph 48 to measure the fair value of a group of financial assets and financial liabilities entered into with a particular counterparty, the entity shall include the effect of the entity's net exposure to the credit risk of that counterparty or the counterparty's net exposure to the credit risk of the entity in the fair value measurement when market participants would take into account any existing

arrangements that mitigate credit risk exposure in the event of default (eg a master netting agreement with the counterparty or an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party). The fair value measurement shall reflect market participants' expectations about the likelihood that such an arrangement would be legally enforceable in the event of default.

Paragraphs 69, 77 and 80 [emphasis added]

Inputs to valuation techniques

General principles

[…]

69 An entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability (see paragraphs 11 and 12). In some cases those characteristics result in the application of an adjustment, such as a premium or discount (eg a control premium or non-controlling interest discount). However, a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the IFRS that requires or permits the fair value measurement (see paragraphs 13 and 14). Premiums or discounts that reflect size as a characteristic of the entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 80) rather than as a characteristic of the asset or liability (eg a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. **In all cases, if there is a quoted price in an active market (ie a Level 1 input) for an asset or a liability, an entity shall use that price without adjustment when measuring fair value, except as specified in paragraph 79**.

Level 1 inputs

[…]

77 A **quoted price** in an active market provides the most reliable evidence of fair value and shall be used **without adjustment** to measure fair value whenever available, except as specified in paragraph 79.

[…]

80 If an entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments)

and the asset or liability is traded in an active market, **the fair value of the asset or liability shall be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity.** That is the case even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

APPENDIX 3—Interpretations Committee Update—May 2013

IFRS 13 *Fair Value Measurement*—portfolios

The Interpretations Committee received a request to clarify the interaction between the use of Level 1 inputs and the portfolio exception set out in IFRS 13. The portfolio exception in IFRS 13 permits an entity to measure its net exposure to either market risks or credit risk arising from a group of financial assets and financial liabilities in specified circumstances. The portfolio exception was intended to align the valuation of financial instruments for financial reporting with an entity's internal risk management practices. In particular, the issue that was discussed by the Interpretations Committee was whether an entity is:

a. permitted to apply the portfolio exception in IFRS 13 to measure the resulting net risk exposure of a portfolio made up solely with identical Level 1 instruments; or

b. required to measure the financial assets and the financial liabilities of such a portfolio on an individual basis, using the corresponding Level 1 prices for each financial instrument.

In its discussions, the Interpretations Committee observed that, in relation to (a) above, the main question that needs to be addressed is whether an entity:

a. would be required to measure such a net risk exposure on the basis of the Level 1 prices for the individual instruments that comprise that net risk exposure; or

b. would be allowed to consider the net risk exposure as a whole and, consequently, consider adjusting it with any appropriate premiums or discounts.

The Interpretations Committee noted that there was insufficient guidance in the Standard for it to be able to answer this question and so it decided that this issue needs to be considered by the IASB. Accordingly it asked the staff to present the Interpretations Committee's concerns to the IASB.