AGENDA PAPER 5 – APPENDIX 1
18-22 FEBRUARY 2013

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.[1]
- 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).

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,

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

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.