STAFF PAPER

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IASB Meeting

Project	Fair Value Measurement: Unit of Account
Paper topic	Research on the proposed measurements in the Exposure Draft—Summary

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Summary

1. The IASB met in July 2015 to discuss how to proceed with the measurement proposals included in the Exposure Draft ('the ED') *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* (Proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28 and IAS 36 and Illustrative Examples for IFRS 13).

2. The ED proposed that:

   (a) the fair value measurement of investments in subsidiaries, joint ventures and associates that are quoted in an active market ('quoted investments') should be based on the product of the quoted price for the individual financial instruments that make up the investment (P) and the quantity of financial instruments (Q), ie P × Q; and

   (b) the recoverable amount of cash-generating units (CGUs) on the basis of fair value less costs of disposal when they correspond to entities that are quoted in an active market (quoted CGUs) should be the product of the quoted price (P) and the quantity of financial instruments held (Q), or P × Q.

3. At the July 2015 meeting, the IASB tentatively decided that further research should be undertaken with respect to the fair value measurement of quoted investments

and with respect to the measurement of the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal.

4. For the purpose of undertaking this research, the staff have undertaken an assessment of the population of entities that would be affected by the proposals in the ED and have gathered input from a wide range of stakeholders. We have conducted outreach with valuation specialists, accounting firms, users of financial statements, securities regulators, the Accounting Standards Advisory Forum (ASAF), staff of the Financial Accounting Standards Board (FASB), the Global Preparers Forum (GPF) and preparers. In addition, the research also includes an academic literature review.

5. The papers presented to the IASB at this meeting entail the assessment of the population of entities that would be affected by the proposals in the ED (see paragraphs 7–21) and the feedback received from valuation specialists, accounting firms, securities regulators, ASAF and FASB staff (see paragraphs 22–31). In a forthcoming meeting, we will provide the IASB with the outcome of the academic literature review along with the feedback received from users, GPF and preparers.

6. We are not asking the IASB to make any decisions at this meeting.

Assessment of the population

7. As part of our research we focussed our attention on the assessment of the population of entities that would be affected by the proposals in the ED. These are entities that have quoted investments in subsidiaries, joint ventures and associates that are required [R] or are permitted [P] to measure those investments at fair value (see Figure 1 in paragraph 14). This assessment can also be seen as forming part of the IASB's commitment to assess the likely effects of proposed new requirements throughout the development of a new or amended Standard in accordance with the *Due Process Handbook*.[1]

8. This assessment was carried out on the basis of the population of entities included in the S&P Capital IQ database ('the database') for which the database contained audited annual reports filed within the last three years (ie 88,258 entities). Assessing the population of entities that would be affected by the ED involved

[1] Paragraphs 3.73–3.76 of the *Due Process Handbook* deal with the Effect Analysis.

performing searches on the database by type of entity (ie investment entities and non-investment entities) and by type of investment held by those entities (ie investments in quoted subsidiaries, joint ventures and associates). In addition, that information had to be filtered for entities that report under IFRS and, in one particular instance, for entities based in jurisdictions in which IFRS is required or permitted in entities' separate financial statements (see paragraphs 18–19).

9. In order to arrive at the results, in some instances, it involved carrying consecutive searches or parallel database searches that then needed to be interlinked because there was no direct way of accessing specific information (see paragraphs 23–25 of Agenda Paper 6B). Even though this assessment meant a number of manual and detailed procedures it was a manageable exercise. However, this was not possible for the cases identified in paragraph 10 of this paper (see paragraph 12).

10. Some respondents to the ED identified that the measurement proposals would also apply to situations not covered in the ED such as the fair value measurement of:

    (a) previously held quoted equity investments in business combinations achieved in stages and quoted non-controlling interests in accordance with IFRS 3 *Business Combinations*;

    (b) quoted investments within the scope of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*; and

    (c) a retained quoted investment after the loss of control in accordance with IFRS 10 *Consolidated Financial Statements*.

11. In addition, the ED also proposed that the recoverable amount of CGUs that corresponded to quoted entities, when measured on the basis of fair value less costs of disposal, should be measured on the basis of P × Q.

12. Widening the assessment of the population to situations described in paragraphs 10–11 of this paper would have entailed a major exercise requiring extensive manual procedures (see paragraphs 9–11 of Agenda Paper 6B). In addition, extrapolating any conclusions from the outcomes of an assessment of the population outlined in paragraphs 10–11 would be further complicated by the fact that some of these instances represent one-time transactions (ie a business combination, investments available for immediate sale or instances in which an

entity loses control of a subsidiary). However, the impact of such transactions on financial statements when they occur could be significant.

13. Even though the conclusions that can be derived from the assessment that follows have their limitations, because it does not encompass all the situations in which the proposed measurement of the ED would apply, the staff believe it to be still useful information in the decision process that the IASB will undertake in this project. In contrast to some of the situations described in paragraph 10, the population assessed in this exercise is a population that could be considered fairly 'stable'. In the case of non-investment entities, investments in subsidiaries, joint ventures and associates are typically considered long-term investments. In the case of investment entities, their investments may suffer more rotation but that should not affect the overall conclusion derived from this assessment.

14. Figure 1 below illustrates the entities subject to the assessment:

	Consolidated financial statements (IFRS 10, IAS 28)	Separate financial statements (IAS 27)
Subsidiaries	▪ When held by an investment entity [R]	▪ When held by an investment entity [R] ▪ When not held by an investment entity [P]
Joint ventures/ Associates	▪ When held by a venture capital organisation, mutual fund, unit trust and similar entities [P]	▪ When held by venture capital organisations, etc, if they have been measured at fair value in the consolidated financial statements [R] ▪ When not held by venture capital organisations, etc [P]

15. The database includes 88,258 entities for which it held audited annual reports filed within the last three years. The assessment carried out shows that for the entities included in the table above (investment entities, venture capital organisations, mutual funds, unit trust and similar entities and non-investment entities) it is not common for them to have interests in quoted investments.

16. In the case of investment entities, which are required to measure subsidiaries at fair value in accordance with IFRS 10, only 3.60 per cent of a population of 2,559

investment entities subject to the assessment had investments in quoted subsidiaries.[2] When considering how many of those investment entities had investments in quoted subsidiaries and reported under IFRS, that percentage decreased to 2.03 per cent (see paragraphs 15–21 of Agenda Paper 6B).

17. Similar outcomes were noted for venture capital organisations, mutual funds, unit trusts and similar entities. These entities are permitted to measure investments in joint ventures and associates at fair value in accordance with IAS 28 *Investments in Associates and Joint Ventures*. Because these entities typically manage their investments on a fair value basis, it is expected that these entities would, for the most part, be using the measurement exception in IAS 28 and measuring their investments in joint ventures and associates at fair value. Out of the population of 2,559 investment entities mentioned above, 6.88 per cent held investments in quoted joint ventures and associates.[3] When considering entities that reported in accordance with IFRS, the percentage of investment entities that held investments in quoted joint ventures and associates and reported in accordance with IFRS decreased to 3.91 per cent of the population of investment entities subject to the assessment (see paragraphs 22–28 of Agenda Paper 6B).

18. The assessment carried out for non-investment entities considered an initial population of 85,699 entities. The proposed measurement in the ED would only affect non-investment entities in the case in which these entities had chosen fair value as a measurement basis when accounting for their investments in subsidiaries, joint ventures and associates in their separate financial statements. We noted that only 6.79 per cent of the total population of non-investment entities had investments in quoted subsidiaries and only 1.66 per cent had investments in quoted joint ventures and associates. When considering non-investment entities that have quoted subsidiaries or quoted joint ventures and associates that report under IFRS and are based in jurisdictions where IFRS is required or permitted for separate financial statements, those percentages decrease to 2.66 per cent and 0.63

[2] Out of the 88,258 entities subject to this assessment, the database only classified 2,559 entities as investment entities (see paragraph 15 of Agenda Paper 6B).

[3] Paragraph 22 of Agenda Paper 6B details the reason why the population of 2,559 investment entities has been considered as a starting-point for the assessment of the population in the case of venture capital organisations, mutual funds, unit trusts and similar entities.

per cent of the initial population analysed (see paragraphs 29–47 of Agenda Paper 6B).

19. Because non-investment entities have a measurement option in their separate financial statements when accounting for their investments in subsidiaries, joint ventures and associates, we sampled 25 non-investment entities holding investments in quoted subsidiaries and 25 non-investment entities holding investments in quoted joint ventures and associates, to identify what measurement basis those non-investment entities chose in their separate financial statements. Manual inspection of separate financial statements was required in this case because an automated database search request was not possible for the parameters under consideration. We noted that all 50 entities sampled had chosen cost to measure their investments in quoted subsidiaries, joint ventures and associates in their separate financial statements.

20. Without considering the situations described in paragraph 10 of this paper, the assessment of the population of entities that would be affected by the proposals in the ED reflects the fact that the proposed requirements would be affecting a limited number of entities and that those entities would be primarily investment entities. This is because non-investment entities seem to be predominantly using cost as the measurement basis when accounting for investments in subsidiaries, joint ventures and associates in their separate financial statements.

21. This conclusion is further corroborated by, and aligned with, the feedback received from different constituents with whom we conducted outreach as part of this process. Indeed, similar feedback was received from the accounting firms (see paragraph 70 of Agenda Paper 6B), ASAF members (see paragraph 108 of Agenda Paper 6B) and securities regulators (see paragraph 89 of Agenda Paper 6B). These comments could be extended to cover the question of how prevalent CGUs that correspond to quoted entities are. The majority of the parties contacted have mentioned that such a case is possible but rare.

Feedback received

22. The following paragraphs summarise the feedback received from valuation specialists, accounting firms, ASAF, securities regulators and FASB staff. The detailed feedback received from all of these constituents is included in Agenda Paper 6B.

23. The main common denominator of the feedback received from these constituents is that measuring the fair value of a quoted investment by applying P × Q does not necessarily result in a measurement that is relevant for the unit of account being measured at fair value (ie the investment as a whole). For many of the parties contacted, P × Q is definitely a relevant reference. Nevertheless, it is generally used mainly as a reasonableness check when measuring the fair value of a quoted investment or when measuring the recoverable amount of a quoted CGU on the basis of fair value less costs of disposal, but it is not necessarily used as the primary and sole technique without first questioning the appropriateness of its results considering the item that is being measured at fair value.

24. An exception to this feedback was the comments received from some securities regulators. For one of the securities regulators contacted and for some of the members of a second securities regulator contacted, P × Q is the preferred measurement method. The features of P × Q that makes it the preferable method for those securities regulators is its verifiability, reliability and objectivity. In most of the cases, those securities regulators also think that P × Q is an appropriate method for measuring the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal (see paragraphs 92–95 and 101–102 of Agenda Paper 6B). In contrast, some of the members of the second securities regulator are of the view that the measurement resulting from P × Q is not relevant for measuring the fair value of quoted investments or for measuring the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal. Those members provided similar reasons to the ones shared by the constituents referred to in the following paragraphs.

25. Valuation specialists generally commented that P × Q does not result in a relevant measurement, because the quoted price of a share does not necessarily reflect all the features of the whole investment being measured at fair value (in some cases,

the price of a single share may be ignoring factors such as specific rights or liquidity restrictions that would be factored in when measuring an entire investment). They noted that P × Q is instead generally used only as a reasonableness check when measuring the fair value of quoted investments. In this regard, valuation specialists typically reconcile any differences between the measurement obtained by using valuation techniques and the measurement derived by applying P × Q. This reconciliation is also an insightful exercise to understand the main reconciling items between the two measurements and to provide additional assurance on the appropriateness of the measurement obtained. In addition, valuation specialists typically noted that P × Q would not represent an exit price for investments in subsidiaries, joint ventures and associates, because the principal market for the sale of those holdings would not be the open market but instead markets such as, for example, the mergers and acquisition market.

26. Measuring fair value by aiming to reflect the features of the investments does not mean that some of the challenges implied in the measurement of some of those features such as, for example, measuring the impact of 'control' through the inclusion of a 'control premium' in the measurement, are omitted or not acknowledged. Indeed, many valuation specialists commented that some of these adjustments involve a high degree of judgement and that in some cases the availability of supporting evidence is limited.

27. When discussing what the most commonly used valuation techniques are, valuation specialists commented that the discounted cash flow method is one of the most common valuation techniques used when measuring the fair value of quoted investments. This technique is also the most commonly used valuation technique when measuring the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal. In that respect, valuation specialists commented that P × Q is rarely used as the primary valuation technique. As previously mentioned, this measurement is instead used as a tool to check the reasonableness of the measurements obtained by applying other valuation techniques.

28. The comments received from the accounting firms reiterated the fact that P × Q is not a relevant measurement for the investment as a whole, because there is no Level 1 price for that unit of account. In addition, the measurement resulting from

applying P × Q does not represent an exit price that is consistent with a market participants' perspective (ie P × Q would rarely reflect the value for which those investments will be realised). P × Q has also been found not to be a relevant measurement for those cases in which entities have a relatively small free-float with a large (unquoted) percentage, for example, being held by a single controlling investor. In this case, some accounting firms question whether that Level 1 price available for the small free-float is relevant for the measurement of the investor's controlling interest. In addition, that free-float may consist of shares that may not be traded frequently, which would put pressure on determining whether that Level 1 price represents the quoted price in an 'active market'.

29. Similar comments were also provided about the measurement of the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal. In this case, accounting firms did not think that the exit price for the group of assets that constitute the CGU would be represented by the price of the shares of the entity. In addition, they commented that it was not common for a CGU to exactly correspond to a quoted entity and, consequently, this would imply that Level 1 prices would need to be adjusted to factor in any differences between the CGU and the quoted entity. Some accounting firms also requested further clarity on the instances in which the proposals would apply exactly (see paragraph 75 of Agenda Paper 6B).

30. Some ASAF members shared similar comments about the lack of relevance of the measurement, which they backed up by citing its inconsistency with the unit of account. A few ASAF members supported the relevance of P × Q in instances in which investments are not disposed as a block or in instances in which the control premium was relatively small (see paragraph109 of Agenda Paper 6B). In relation to the relevance of the measurement of the recoverable amount of quoted CGUs on the basis of fair value less costs of disposal, it was argued that the relevance of such a measurement would depend on how closely aligned the CGU and the quoted entity are, and it was highlighted that a consequence of such proposals would be a lack of alignment between the measurement of the recoverable amount between quoted and unquoted CGUs.

31. We also contacted the FASB staff to understand whether the fair measurement of quoted investments and the measurement of the recoverable amount of quoted

CGUs on the basis of fair value less costs of disposal had been identified as a significant issue in the Post-implementation Review (PIR) on the fair value Standard that the Financial Accounting Foundation finalised in 2014. According to the FASB staff, this issue was not identified as a significant issue in the PIR. In addition, the FASB staff are not aware of any requests for clarification on these matters either.

Concluding comments from the work done so far

32. The results arising from the research work carried out far highlight two main messages. The first one is that, excluding those instances described in paragraph 10 of this paper, the proposals in the ED are initially thought likely to affect only a very limited number of entities. The second message is that the majority of parties contacted so far do not think that the resulting measurement from applying P × Q is a relevant measurement. We note that the feedback from users of financial statements, preparers, GPF and input from the academic review has not yet been included in this first summary of the results.