 Proposed clarifications of unit of account and fair value measurement requirements

**What you need to know**

- The IASB has proposed clarifications to the requirements for measuring fair value, in accordance with IFRS 13 *Fair Value Measurement*, for investments in subsidiaries, joint ventures, associates and CGUs:
  - The unit of account for investments in subsidiaries, joint ventures and associates would be the investment as whole.
  - When a quoted price in an active market is available for the individual financial instruments that comprise the entire investment, the fair value measurement would be the product of the quoted price of the financial instrument (P) multiplied by the quantity (Q) of instruments held (i.e., price x quantity, P × Q).
  - When testing CGUs for impairment, if they correspond to an entity whose financial instruments are quoted in an active market, the fair value measurement is the product of P × Q.
  - The exposure draft also proposes to include an example to illustrate application of the requirements in IFRS 13, when the portfolio approach is applied, to a portfolio of investments for which quoted prices in an active market are available.
  - Comments on the exposure draft are due by 16 January 2015.

**Highlights**

The International Accounting Standards Board (IASB or Board) issued *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) (ED)* in September 2014 to address the following practice issues:

- What is the unit of account for subsidiaries, joint ventures and associates?
- How do the requirements in IFRS 13 interact with the unit of account for subsidiaries, joint ventures, associates, cash-generating units (CGUs) and portfolios comprised of investments for which quoted prices in an active market are available?

**Proposed unit of account for investments in subsidiaries, joint ventures and associates**

The identification of the asset or liability to be measured is fundamental to determining its fair value. Unit of account is an accounting concept that determines the level at which an asset or liability is aggregated or disaggregated for the purposes of applying IFRS 13 and other standards.
Unless specifically addressed in IFRS 13, the appropriate unit of account is determined by the standard that permits or requires the fair value measurement or disclosure.

For investments in subsidiaries, joint ventures and associates, an entity needs to look to IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures to determine the relevant unit of account. However, these standards do not provide explicit guidance on the relevant unit of account. Furthermore, the measurement requirements in IFRS 10, IAS 27 and IAS 28 refer to IFRS 9 Financial Instruments, which permits or requires an investment to be accounted for in accordance with that standard in certain circumstances. This has led to questions about the extent to which the requirements of IFRS 9 apply. Would only the measurement basis specified in IFRS 9 (i.e., fair value through profit or loss) apply or would IFRS 9 also prescribe the unit of account (i.e., the individual financial instruments that, in aggregate, comprise the investment as a whole)?

The Basis for Conclusions to the ED states that the unit of account for investments in subsidiaries, joint ventures and associates would be the investment as whole, and not the individual financial instruments (i.e., shares) that constitute the investment.

**Interaction between unit of account and the measurement requirements in IFRS 13**

**Investments in subsidiaries, joint ventures and associates**

When an entity holds a position in a single asset or liability that is traded in an active market (including a position comprising a large number of identical assets or liabilities), IFRS 13 requires it to measure fair value using the quoted price without adjustment. This requirement is accepted when the asset or liability being measured is a financial instrument in the scope of IFRS 9 or IAS 39 Financial Instruments: Recognition and Measurement.

However, when an entity holds an investment in a subsidiary, joint venture or associate, current valuation techniques sometimes include an adjustment (e.g., a control premium) to reflect, for example, the value of the investor’s control, joint control or significant influence over the investee.

IFRS 13 requires entities to select inputs that are consistent with the characteristics of the asset or liability being measured and that would be considered by market participants when pricing the asset or liability. Apart from block discounts (which are specifically prohibited), determining whether a premium or discount can be included in a particular fair value measurement requires judgement and depends on specific facts and circumstances.

IFRS 13 states that premiums or discounts should not be incorporated in fair value measurements unless all of the following conditions are met:

- The application of the premium or discount reflects the characteristics of the asset or liability being measured
- Market participants, acting in their economic best interest, would consider that premium or discount when pricing the asset or liability
- The inclusion of the premium or discount is not inconsistent with the unit of account in the IFRS that requires or permits the fair value measurement

Therefore, if the unit of account is deemed to be the investment as a whole, it would be appropriate to include, for example, a control premium when determining fair value, provided that market participants take this into consideration when pricing the asset.

However, if a quoted price in an active market is available for individual shares in the subsidiary, joint venture or associate, should the requirement to use \( P \times Q \) without adjustment to measure the fair value override the requirements relating to premiums or discounts? This question is applicable even when the unit of account is the entire investment.
The ED proposes that, for investments that are comprised of financial instruments for which a Level 1 price is available, the requirement to use \( P \times Q \) takes precedence irrespective of the unit of account. Therefore, for all such investments, the fair value measurement is the product of \( P \times Q \), even when the reporting entity has an interest that gives it control, joint control or significant influence over the investee.

**Impairment testing of investments that are quoted in an active market**

When testing for impairment in accordance with IAS 36 *Impairment of Assets*, the recoverable amount of an asset or CGU is the higher of its value in use and fair value less costs of disposal. The fair value component of fair value less costs of disposal is required to be measured in accordance with IFRS 13.

When the asset or CGU corresponds to an investment in a listed entity, the same issue arises as to whether the requirement to use \( P \times Q \), without adjustment, to measure fair value would apply. Consistent with the proposals for listed investments in subsidiaries, associates and joint ventures, the ED proposes that the requirement to use \( P \times Q \) would also apply.

**Portfolios comprised of instruments for which Level 1 prices are available**

IFRS 13 provides an exception to its principles, allowing entities to measure a group of financial instruments based on the price to sell (or transfer) its net position for a particular risk exposure, if certain criteria are met (the portfolio approach).

There is some debate about whether IFRS 13 prescribes the unit of account in relation to the portfolio approach. Some believe the portfolio approach effectively changes the unit of account for any financial instruments within the portfolio(s) to the net exposure of the portfolio to a particular risk. This may have a number of consequences. For example, the entity may be able to include premiums or discounts in the fair value measurement of the portfolio that are consistent with that unit of account, but not the individual instruments that make up the portfolio. In addition, because the net exposure for the identified group may not be actively traded (even though some financial instruments within the portfolio may be) \( P \times Q \) may not be applied to the actively traded instruments within the portfolio. Others believe that the portfolio approach does not override the unit of account as provided in IAS 39 or IFRS 9. Therefore, any premiums or discounts that are inconsistent with this unit of account would be excluded.

Regardless of which view is taken, it is clear in IFRS 13 that the portfolio approach does not change the financial statement presentation requirements. As such, the use of this approach may also require a reporting entity to allocate portfolio-level valuation adjustments for disclosure purposes.

The ED proposes to include an example in IFRS 13 to illustrate application of the portfolio approach to portfolios that are solely comprised of instruments for which Level 1 prices are available. It does not address portfolios that include other financial instruments for which Level 1 prices are not available. Nor does it illustrate how an entity would allocate the measurement of a portfolio to the instruments within it for disclosure purposes.

The illustrative example suggests that an entity would measure the net long or net short position in accordance with the corresponding Level 1 prices. Furthermore, it indicates that the resulting measurement could be achieved by measuring the net position at the mid-price, adjusted by a bid-offer spread.
**Proposed transition requirements**

The IASB has proposed the following transition requirements:

- For quoted investments in subsidiaries, joint ventures and associates, an entity would recognise a cumulative catch-up adjustment to opening retained earnings for the period in which the proposed amendments are first applied. The entity would then recognise the change in measurement of the quoted investments during that period in profit or loss (i.e., retrospective application).

- For impairment testing in accordance with IAS 36, an entity would apply the requirements on a prospective basis. If an entity incurs an impairment loss or reversal during the period of initial application, it would provide quantitative information about the likely effect on the impairment loss/reversal amount had the amendments been applied in the immediately preceding period presented.

The ED clarifications regarding application of the portfolio approach could potentially lead to a change practice for some entities. However, since the IASB has only proposed the inclusion of an illustrative example, no transition requirements have been proposed for the portfolio approach.

The ED does not include a proposed effective date. However, it permits early adoption. Furthermore, a first-time adopter of IFRS would be able to apply the amendments at the beginning of the earliest period for which it presents full comparative information under IFRS in its first IFRS financial statements (i.e., prospectively from the date of the first-time adopter’s transition to IFRS).

**How we see it**

The proposed amendments would provide useful clarifications of how the Board views the interaction between unit of account and the requirements in IFRS 13 when Level 1 prices are available. However, it is unclear why some of the proposed clarifications would only be within the Basis for Conclusions or the Illustrative Examples, rather than within the relevant standards.

While the proposed amendments for subsidiaries, joint ventures associates and CGUs may be operationally simple for preparers to apply, the result may be counterintuitive, particularly if they lead to additional impairment losses being recognised.

Additional guidance may be needed to assist entities in applying the portfolio approach to portfolios that include instruments for which quoted prices in an active market are available and for portfolios that include some instruments for which quoted prices in an active market are not available. For example, it is not clear whether the analysis in the proposed example is intended to apply only to the fact pattern illustrated or more broadly. In addition, it is not clear how this would interact with the practical expedient in paragraph 71 of IFRS 13, which permits entities to use mid-market pricing.

If the Board proceeds with the proposed amendments, they could have a significant impact on entities, whether they are recognising their investments at fair value, measuring the fair value of a portfolio, or using fair value measurement as part of an impairment test. It is, therefore, unclear why the proposed transition requirements include a mix of prospective and retrospective application and why no transition requirements have been included in relation to the proposed clarifications of the application of the portfolio approach in IFRS 13.

**Next steps**

Comments are due by 16 January 2015. We encourage constituents to take the opportunity to respond to the Board.