Financial Reporting Council

IFRS Foundation
30 Cannon Street
London
EC4M 6XH

28 January 2015

Dear Sirs

Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value (Exposure Draft ED/2014/4)

1. This letter sets out the comments of the UK Financial Reporting Council (FRC) on the above Exposure Draft.

2. We note that the aim of the Exposure Draft is to clarify the application of fair value in certain circumstances and that comments are not requested on aspects of those standards that it does not address. This response therefore does not comment on whether fair value is an appropriate measurement basis in the circumstances in which it is required or permitted by IFRSs.

3. We agree that the unit of account for investments in subsidiaries, associates and joint ventures is the investment as a whole rather than the individual financial instruments within that investment.

4. In our view, the fair value of that investment will not correspond to the product of the quoted price and the quantity of the individual financial instruments held (P×Q), as the fair value of the investment will include a control premium or, perhaps less commonly, a discount. It follows that fair value should be measured by another valuation technique.

5. However, we can understand that some may favour the use of a P×Q measurement as a pragmatic departure from the principles of fair value, as it is more objective and verifiable and hence more useful to users of financial statements, and would apply only in the limited circumstances addressed in the Exposure Draft. If the IASB were to adopt this course, it would be important that the Basis for Conclusions clearly set out the reasons for the departure from the principles of fair value.

6. We enlarge on these views in the following sections of this letter. Our responses to the questions for respondents set out in the Exposure Draft are given in the Appendix.

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Fair value approach (including control premiums)

7. The definition of fair value in IFRS 13 'Fair Value Measurement' is:

   'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.'

   Given that the unit of account is the investment as a whole, it follows that fair value would include a control premium (or discount), as that would be included in the price received in the event of a sale as envisaged in the definition.

8. The use of fair value, including control premiums is also consistent with IFRS 13. As noted in the Exposure Draft at paragraph BC8(a) there is no Level 1 price for the investment as a whole: it follows that the exhortations in IFRS 13 to maximise the use of observable inputs, and to use Level 1 inputs without adjustment are inapplicable.

9. IFRS 13 addresses the question of including a premium or a discount in a fair value measurement (in paragraph 69). It states that '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' and acknowledges that a control premium may be reflected.

10. A significant advantage of the use of fair value is that it avoids the immediate write-off of any control premium paid on the acquisition of an investment. This does not represent a genuine economic loss and has the consequence that a subsequent sale may give rise to a reported profit even if the proceeds are less than the amount originally invested. More generally, fair value assists an assessment of stewardship, as management would continue to be accountable for the full cost of their investment.

11. A serious concern with the proposed amendments are that they will create an inconsistency in the measurement of quoted and unquoted investments, as a control premium will be reflected in the Level 2 or Level 3 measurements of the latter.

The P×Q approach

12. Although we do not agree that a PxQ approach is an interpretation of fair value, we accept that it may be required as a pragmatic departure that would apply in limited circumstances. If this course is adopted, it is important that it is clearly identified as a departure from fair value in the standards and in the Basis for Conclusions.

13. Some consider that a PxQ approach may be justified as the asset is not fungible with other assets—in virtually all cases it will be unique, and it is therefore not possible to measure reliably the amount of such a discount or premium. Although fair value is used in other cases where there is limited information on market prices (for example for unquoted investments), they consider that a P×Q measurement reflects some market information and might therefore be used for the quoted investments addressed in the Exposure Draft.

14. We do not share the IASB's view in paragraph BC10 of the Exposure Draft that a P×Q measurement is more relevant than one that reflects a control premium. However, those who would support such a measurement note that it is more objective and verifiable and, because it is more reliable, more useful to users of financial statements. In their view, the issue is a classic illustration of the need to judge the best obtainable balance of relevance and reliability. One reason a P×Q measurement may be considered more useful than a hypothetical fair value is that the user of financial statements knows precisely what it represents, and it therefore provides a firm basis for users to derive their own view of the value of the investment.

15. If a P×Q measurement is to be required as proposed, disclosure of its use should be required. This should include the write-off of any control premium paid on the acquisition of an investment.

Fair value of quoted CGUs

16. The Introduction and Basis for Conclusions to the Exposure Draft state that one of its aims is to clarify the fair value measurement of cash-generating units (CGUs) that correspond to entities that are quoted in an active market. However, the proposed amendment to IAS 36 'Impairment of Assets' addresses the case where an asset is an investment in a subsidiary, joint venture or associate. It therefore will have no effect on the consolidated financial statements where the CGU corresponds to a subsidiary, as the consolidated financial statements will not include an asset that is an investment in a subsidiary. It would be helpful if this were clarified.

17. In any event, we would disagree with a P×Q measurement in the consolidated financial statements, as there seems little relevance in allocating the resulting impairment to the various classes of assets and liabilities that form part of the CGU.

Placement of amendments

18. IFRS 13 was developed in order to provide a framework for measuring fair value in a single IFRS, as it was unsatisfactory for references to issues relating to fair value measurement to be scattered throughout individual IFRSs. It is therefore surprising that the Exposure Draft proposes amendments to five IFRSs, and to add an Illustrative Example to IFRS 13. The main text of IFRS 13 is not to be changed, so it will cease to provide a comprehensive codification of the application of fair value under IFRSs. If the IASB concludes (contrary to our view) that the requirement to use a PxQ measurement is a clarification of the principles of fair value, it would be preferable for IFRS 13 to be revised so that all relevant material on fair value measurement continues to be contained in one standard. (Although, of course, it may be helpful for individual standards to be amended by the insertion of cross-references to IFRS 13, as amended.)

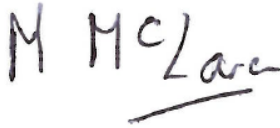
Draft Bases for Conclusions

19. We are also concerned that the draft Bases for Conclusions to the various amendments are inadequate. They merely add footnotes that note the issue of the amendment and repeat its substance, rather than setting out a rationale. In contrast the present Exposure Draft sets out its rationale in 35 paragraphs, which presumably will disappear when the amendments become final. In our

view it is important that the Basis for Conclusions provides a summary of the Board's reasoning in reaching its conclusions.

20. If you would like to discuss these comments, please contact me or Andrew Lennard (a.lennard@frc.org.uk).

Yours sincerely



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Appendix:

Response to the questions for respondents set out in the Exposure Draft

Question 1—The unit of account for investments in subsidiaries, joint ventures and associates

The IASB concluded that the unit of account for investments within the scope of IFRS 10, IAS 27 and IAS 28 is the investment as a whole rather than the individual financial instruments included within that investment (see paragraphs BC3–BC7).

Do you agree with this conclusion? If not, why and what alternative do you propose?

A1 We agree with the conclusion for the reasons set out in the Basis for Conclusions on the Exposure Draft.

Question 2—Interaction between Level 1 inputs and the unit of account for investments in subsidiaries, joint ventures and associates

The IASB proposes to amend IFRS 10, IFRS 12, IAS 27 and IAS 28 to clarify that the fair value measurement of quoted investments in subsidiaries, joint ventures and associates should be the product of the quoted price (P) multiplied by the quantity of financial instruments held (Q), or P×Q, without adjustments (see paragraphs BC8–BC14).

Do you agree with the proposed amendments? If not, why and what alternative do you propose? Please explain your reasons, including commenting on the usefulness of the information provided to users of financial statements.

A2 We do not agree with the proposed amendments. Fair value, as defined in IFRS 13, requires that the fair value of an investment in a subsidiary, joint venture or associate should include a control premium or discount, which is not reflected in a P×Q measurement.

A3 However, we can understand that the IASB may wish to require a P×Q measurement to be used in the circumstances addressed in the Exposure Draft, as a pragmatic departure from the principles of fair value, on the grounds that a P×Q measurement is more objective and verifiable and, because it is more reliable, more useful to users of financial statements. This should not be presented as a clarification of fair value, but acknowledged as a departure. If the IASB decides to

pursue this course, it should consider disclosure requirements and the effect of the inconsistency that it will introduce between quoted and unquoted investments.

Question 3—Measuring the fair value of a CGU that corresponds to a quoted entity

The IASB proposes to align the fair value measurement of a quoted CGU to the fair value measurement of a quoted investment. It proposes to amend IAS 36 to clarify that the recoverable amount of a CGU that corresponds to a quoted entity measured on the basis of fair value less costs of disposal should be the product of the quoted price (P) multiplied by the quantity of financial instruments held (Q), or P×Q, without adjustments (see paragraphs BC15–BC19). To determine fair value less costs of disposal, disposal costs are deducted from the fair value amount measured on this basis.

Do you agree with the proposed amendments? If not, why and what alternative do you propose?

A4 As in the case of investments in subsidiaries, joint ventures and associates, the principles of fair value require that a control premium be included, but a P×Q measurement may be justified as a pragmatic exception that applies in limited circumstances.

A5 We note that the amendment would not seem to affect consolidated financial statements where a CGU corresponds to a quoted subsidiary. We do not agree that a P×Q measurement should be used in such circumstances, as there is limited relevance in allocating an impairment based on such a measurement to the various classes of assets and liabilities of the CGU that are reported in the consolidated financial statements. If the amendment is intended to apply in such a case, this needs to be clarified.

A6 Similarly, the implications of the amendment for equity accounted entities in both consolidated and separate financial statements should be clarified.

Question 4—Portfolios

The IASB proposes to include an illustrative example to IFRS 13 to illustrate the application of paragraph 48 of that Standard to a group of financial assets and financial liabilities whose market risks are substantially the same and whose fair value measurement is categorised within Level 1 of the fair value hierarchy. The example illustrates that the fair value of an entity's net exposure to market risks arising from such a group of financial assets and financial liabilities is to be measured in accordance with the corresponding Level 1 prices.

Do you think that the proposed additional illustrative example for IFRS 13 illustrates the application of paragraph 48 of IFRS 13? If not, why and what alternative do you propose?

A7 We agree with the approach taken in the illustrative example. However, we do not believe that divergent interpretations of the requirements of IFRS 13 can be resolved simply by adding such an example: in addition the text needs to be amended to specify the correct approach. We note that the rubric to the Illustrative Examples in IFRS 13 reads:

> *These examples accompany, but are not part of, IFRS 13. They illustrate aspects of IFRS 13 but are not intended to provide illustrative guidance.*

A8 From a legal perspective the addition of a new illustrative example will have no effect in Europe, as illustrative examples that are not part of a standard do not form part of EU adopted IFRS.

Question 5—Transition provisions

The IASB proposes that for the amendments to IFRS 10, IAS 27 and IAS 28, an entity should adjust its opening retained earnings, or other component of equity, as appropriate, to account for any difference between the previous carrying amount of the quoted investment(s) in subsidiaries, joint ventures or associates and the carrying amount of those quoted investment(s) at the beginning of the reporting period in which the amendments are applied. The IASB proposes that the amendments to IFRS 12 and IAS 36 should be applied prospectively.

The IASB also proposes disclosure requirements on transition (see paragraphs BC32–BC33) and to permit early application (see paragraph BC35).

Do you agree with the transition methods proposed (see paragraphs BC30–BC35)? If not, why and what alternative do you propose?

IFRS 10, IAS 27 and IAS 28

A9 We do not agree with the proposed transition methods for the amendments to IFRS 10, IAS 27 and IAS 28. In our view, retrospective application provides superior information as it preserves comparability between accounting periods. The proposed amendments apply only to investments that are quoted on an active market: retrospective application is therefore unlikely to involve undue cost or effort, as the fair value on a P×Q basis can be readily obtained.

A10 The Exposure Draft notes that prospective application was prescribed in the case of IFRS 13. However, as noted in BC 229 of IFRS 13, that was based on the difficulty of distinguishing changes in an estimate of fair value from a change in method of assessing fair value. In the present case, it is clear that the whole of the difference from a previously reported fair value and that obtained using the P×Q method results from a change in method.

IFRS 12

A11 We also do not agree that the amendment to IFRS 12 should be applied prospectively. This amendment relates to disclosure of quoted joint ventures and associates that are equity accounted. The Basis for Conclusions suggests (in paragraph BC34) that prospective application is appropriate, because disclosure about the impact of transition will compensate for any lack of comparability between the amount disclosed when the amendment is first applied and the immediately

preceding reporting period. The disclosure that is referred to is about the impact of the amendments on retained earnings (or other component of equity). However, as the joint venture or associate is equity accounted, the amendments would have no effect on balance sheet amounts. The logic of the rationale in the Basis for Conclusions is therefore unclear.

A12 In our view, the amendment to IFRS 12 should be applied retrospectively, with disclosure of the difference between the amount on the PxQ basis and that previously reported for the first period for which amounts are presented in accordance with the amendment. As noted above, a measurement on a PxQ basis would seem to involve minimal cost or effort.

IAS 36

A13 We agree that the amendment to IAS 36 should be applied prospectively, because, as noted in the Exposure Draft at BC33, retrospective implementation may result in undue cost.

A14 The Exposure Draft proposes that disclosure is required about impairments arising in the period preceding that in which the amendment is applied. The Basis for Conclusions describes this as applying to *'entities that have recognised an impairment loss or an impairment loss reversal during the reporting period in which the amendments are first applied'*: in contrast, the proposed amendment applies *'If an entity recognised an impairment loss or an impairment loss reversal as at the date that the amendments referred to in paragraph 140N are initially applied…'*. The wording used in the Basis for Conclusions is clearer and should be used in the final amendment. The wording in the draft amendment could, for example, be interpreted as applying where an entity has ever recognised an impairment loss on an asset that it still owns.