STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	Fair Value Measurement		
Paper topic	Portfolios		
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Introduction

1. The IFRS Interpretations Committee ('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 *Fair Value Measurement*. The submission is reproduced in full in Appendix 1 to this paper.

2. The submission also raised questions about the unit of account of investments in subsidiaries, joint ventures and associates and the interaction between their unit of account and the use of Level 1 inputs in IFRS 13. The International Accounting Standards Board (IASB) discussed this issue in its February and March meetings.

Purpose of this paper

3. This objective of this paper is to:

   (a) provide background information about the portfolio exception (paragraphs 4-11);

   (b) provide a description of the issue submitted (paragraphs 12-24);

   (c) assess the issue by reference to the Interpretations Committee's criteria for taking an issue onto its agenda (paragraph 25); and

   (d) ask the Interpretations Committee whether the issue should be added to the agenda.

Background information—The portfolio exception

4. 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.[1] At that meeting the IASB and the FASB (the boards) decided to permit an exception to fair value measurement principles by permitting entities to measure their net exposure to either market risks or credit risk arising from a group of financial assets and financial liabilities in certain circumstances (see paragraph 48 of IFRS 13, reproduced in Appendix 2).

5. The term 'exception' refers to the fact that, strictly speaking, the measurement of an entity's net exposure to a particular risk does not comply with the definition of fair value, because it does not attempt to estimate the price at which an individual financial asset could be sold or the price at which an individual financial liability could be transferred. An entity is permitted to use the exception for a particular portfolio (ie it is an accounting policy decision in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) if the entity (see paragraph 49 of IFRS 13):

   (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;

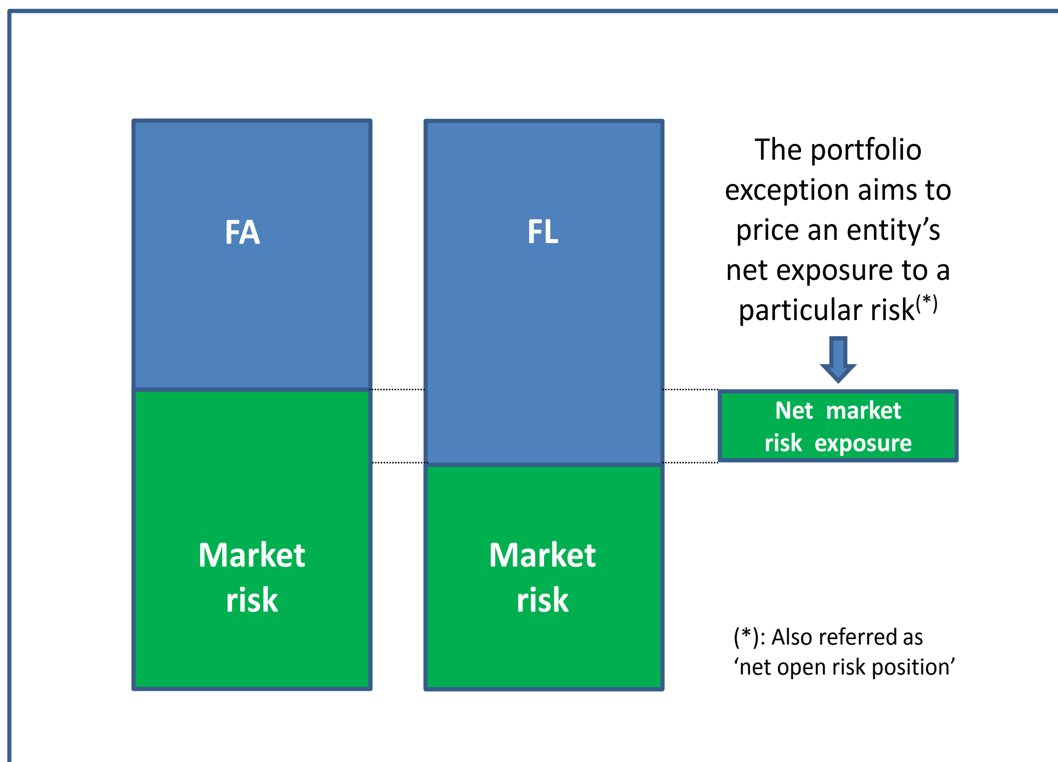
   (b) provides information on that basis about the group of financial assets and financial liabilities to the entity's key management personnel; and

   (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.

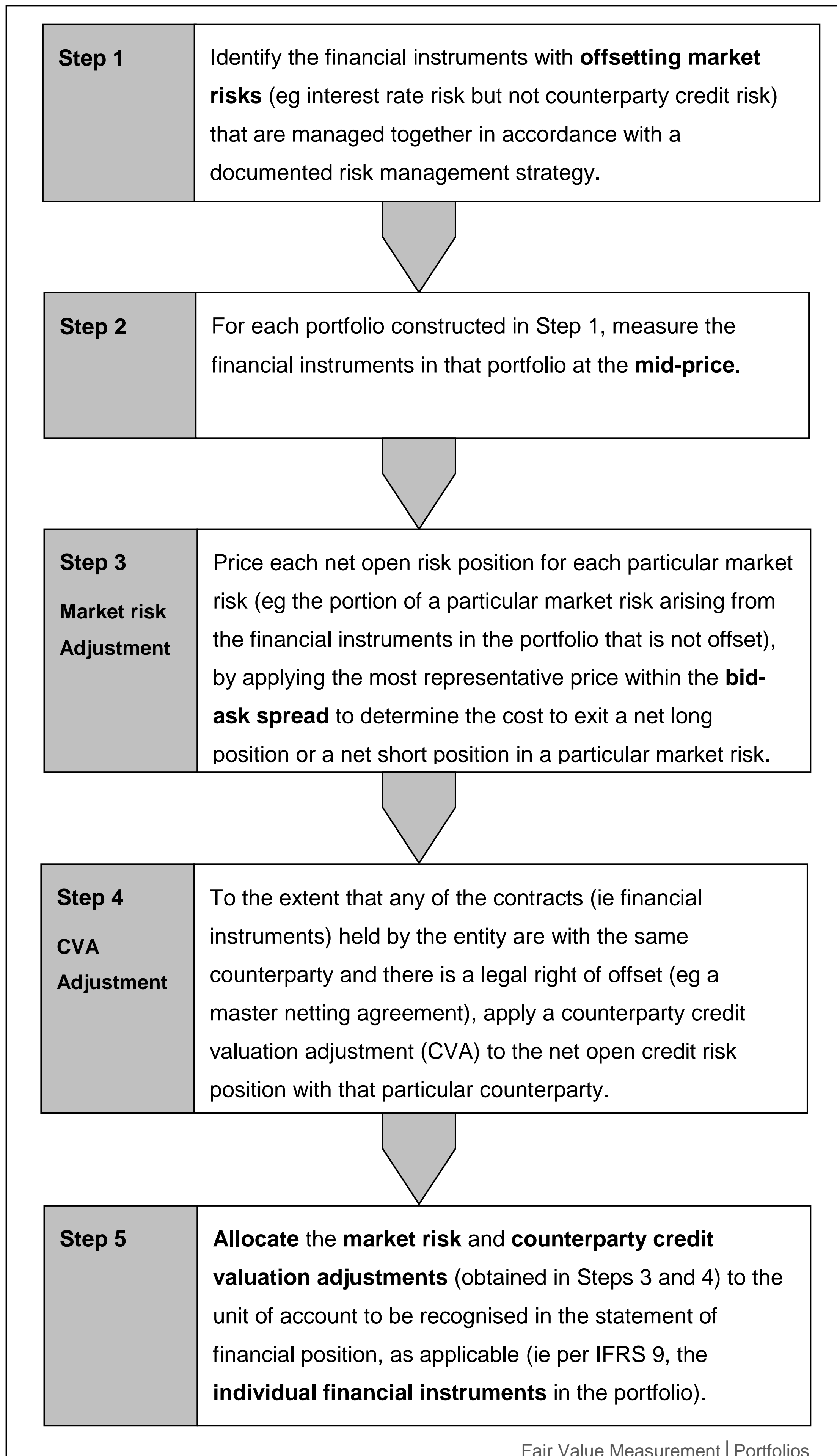
6. The figure below aims to illustrate the measurement resulting from an entity applying the portfolio exception in IFRS 13. Assume that a portfolio consists of two financial instruments, a financial asset (FA) and a financial liability (FL).

[1] 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

These two instruments expose the entity to a particular market risk. When measuring the fair value of FA and FL by applying the portfolio exception, an entity would be allowed to price that particular market risk to which the entity is exposed from FA and FL on a net basis. If the entity did not apply the portfolio exception when measuring the fair value of FA and FL, the entity would consider that particular market risk for FA and for FL on an individual basis, without taking into account whether part of that market risk that both FA and FL have in common can be offset.



7. The process for measuring the fair value of financial instruments within a portfolio is described in the following chart.


Step 1
Identify the financial instruments with offsetting market risks (eg interest rate risk but not counterparty credit risk) that are managed together in accordance with a documented risk management strategy.
Step 2
For each portfolio constructed in Step 1, measure the financial instruments in that portfolio at the mid-price.
Step 3
Market risk Adjustment
Price each net open risk position for each particular market risk (eg the portion of a particular market risk arising from the financial instruments in the portfolio that is not offset), by applying the most representative price within the bid-ask spread to determine the cost to exit a net long position or a net short position in a particular market risk.
Step 4
CVA Adjustment
To the extent that any of the contracts (ie financial instruments) held by the entity are with the same counterparty and there is a legal right of offset (eg a master netting agreement), apply a counterparty credit valuation adjustment (CVA) to the net open credit risk position with that particular counterparty.
Step 5
Allocate the market risk and counterparty credit valuation adjustments (obtained in Steps 3 and 4) to the unit of account to be recognised in the statement of financial position, as applicable (ie per IFRS 9, the individual financial instruments in the portfolio).

Why the exception was permitted in IFRS 13

8. The portfolio exception is intended to align the valuation of financial instruments for financial reporting to the entity's internal risk management practices. It was also intended to maintain existing practice under IAS 39 *Financial Instruments: Recognition and Measurement*.

9. IFRS 13 was drafted with portfolios with a high concentration of unquoted derivatives in mind (ie the portfolio exception was drafted mainly to allow the measurement of risk exposures arising from financial instruments whose fair values would be categorised as Level 2 or Level 3 in the fair value hierarchy on a net basis). The following reasons summarise why the portfolio exception was permitted:

   (a) Entities do not manage financial instruments on the basis of each individual contract (which is the unit of account). Entities generally do not manage their exposure to market risks and credit risk by selling a financial asset or transferring a financial liability. Instead, they buy one or more instruments that offset the risk exposure created by the instrument(s) they hold (see paragraph BC117 (a) of IFRS 13). This is especially true of derivatives.

   (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 them to use inputs based on mid prices irrespective of the direction of the position. The portfolio exception is a practical approach. This is important when an entity has thousands of instruments to measure. Having a consistent valuation basis for all instruments and positions means that entities can identify the natural offsets and manage their risk accordingly.

   (c) 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 as it would be inconsistent with risk management (see paragraph BC115 of IFRS 13).

10. However, as reflected in the submission received, questions have been raised about whether the term 'exception' represents an exception to other principles of the Standard. We think that this is partly because the paragraphs of the Standard dealing with the portfolio exception do not explicitly state their interaction with other principles of the Standard such as:

    (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); and

    (c) not applying blockage factors (see paragraphs 69 and 80 of IFRS 13).[2]

11. The section that follows describes the tension between the portfolio exception and the principles stated above.

The issue presented in the submission

12. The question that has been raised is how to reconcile the unit of account (individual instrument) with the unit of measurement (the net risk exposure), particularly when the portfolio contains instruments categorised within Level 1 of the fair value hierarchy.[3]

13. We will analyse this matter through the following example, which has been adapted from the example included in the submission.[4]

Example

An entity has a long position of 10,000 individual financial assets and a short position of 9,500 individual financial liabilities.

All financial instruments are exactly the same instruments and are categorised in **Level 1** of the fair value hierarchy.

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

[2] 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.

[3] 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.'

[4] It is assumed that for accounting purposes the instruments are shown gross in the statement of financial position.

	Bid	Mid	Ask
Prices (in CU)[5]	98	100	102
Most representative exit price[6]	99		101

14. In this particular example, because the financial instruments are exactly the same, the net open position of the portfolio coincides with the entity's net risk(s) exposure. The example in this case is focussing on the price risk for the entire instrument. If the instruments were **not** exactly the same financial instruments, there would be 'basis risk' because the market risk parameters between the instruments would not be identical. That is, the net risk exposure from the portfolio would not necessarily match the net open position (ie 500 financial assets in the example above) because those financial instruments are different and their market risks would not be completely offset (that is, any basis risk would need to be measured separately so that it could be taken into account in the fair value measurement of those financial assets and financial liabilities by allocating that basis risk (ie any remaining net risk exposure) to those financial instruments accordingly. See paragraph 54 of IFRS 13.) In other words, an entity would need to follow the process described in paragraph 7.

15. In this particular example, the matter that is open for interpretation is whether an entity would be:

    (a) allowed 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.

16. The effect of applying or not applying the portfolio exception for the example above is as follows:

[5] In this example, and in all other examples in this paper, monetary amounts are denominated in 'currency units (CU)'

[6] 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 […].'

PORTFOLIO	Using portfolio exception				Not using portfolio exception	(c) = (a) - (b)	(c) / (b)
	Quantity held (Q)	Quoted market price (P)	P x Q	TOTAL (a)	TOTAL (b)		
Financial assets	9,500	100	950,000				
	500	99	49,500	999,500	990,000 (10,000 x CU99)	9,500	1.0%
Financial liabilities	-9,500	100	-950,000	-950,000	-959,500 (-9,500 x CU101)	9,500	-1.0%
Net long position	**500**	**99**	**49,500**	**49,500**	**30,500**	**19,000**	**62.3%**

17. There are three possible views for an entity to measure the fair value of such a portfolio in accordance with IFRS 13:

(a) View A: this view considers that the unit of valuation is the net risk exposure and that it is irrelevant whether there is a Level 1 input available for the *individual* financial instruments, because the fair value measurement should be based on the characteristics of the net risk exposure. In other words, there is a Level 1 input for an individual financial instrument but not for the net risk exposure. This view would support the contention 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 (as the concept of Level 1 inputs would never be relevant to the net risk exposure).

(b) View B: this view considers that the existence of a Level 1 price takes precedence as a matter of principle and as a matter of reliability.[7] In accordance with this view, the portfolio exception is designed for portfolios containing financial assets and financial liabilities that are categorised within Levels 2 and 3 of the fair value hierarchy. In other words, the portfolio exception cannot be applied to portfolios containing financial assets and financial liabilities for which a Level 1 price exists. One of the reasons provided in Appendix 1 to support this argument is that, for example, any portfolio-level adjustments derived from a portfolio containing financial assets and financial liabilities for which a Level 1 price is available implies an adjustment of the quoted prices for these individual assets and liabilities, which would be inconsistent with paragraphs 69, 77 and 80 of IFRS 13. According to

[7] View B in this paper corresponds to Views 2 and 3 of the submission sent to us, which is in Appendix 1 to this paper.

this view, a second reason for supporting the contention that the portfolio exception cannot be applied to portfolios containing Level 1 financial instruments (for example, a portfolio that includes Level 1 and Level 3 financial instruments) relates to the fact that an entity, when having to recognise those financial instruments based on their unit of account (ie the individual financial instruments) in the statement of financial position, would assign to those individual financial instruments their quoted prices if they are Level 1 instruments. The entity would restrict the allocation of the total portfolio-level adjustments to only the financial assets and financial liabilities that are categorised in Level 3. According to View B, restricting the allocation of the portfolio-level adjustments to the Level 3 financial assets and financial liabilities only would lead to measuring those Level 3 financial instruments in a manner that is not representative of their respective exit prices.

(c) View C: this view considers that an entity would choose to apply the portfolio exception if it maximises value to the entity.[8] Proponents of this view argue that it is supported by paragraph 22 of IFRS 13, which states that a fair value measurement is based on assumptions used by market participants, who act in their economic best interest. This view also relies on the argument stated in paragraph BC67 of IFRS 13, in which 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 that 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 Standards does not prohibit that grouping. According to this view, the guidance in IFRS 13 that requires the use of unadjusted Level 1 inputs for the individual financial instruments if those Level 1 inputs are available (ie paragraphs 69, 77 and 80 of IFRS 13) is dependent on whether the application of the portfolio exception results in a more favourable fair value.

[8] View C in this paper corresponds to View 4 of the letter sent to us, which is in Appendix 1 to this paper.

18. Taking into consideration the fact pattern of the example (see paragraph 13), the views above lead to the following measurements:[9]

 (a) Views A and C would price the net risk exposure arising from the portfolio. In this case, because the financial instruments are identical, pricing the net risk exposure is the same as pricing the portfolio's net position (ie 500 financial assets multiplied by the relevant Level 1 bid price (CU99), P×Q).

 This would result in the valuation of financial instruments for financial reporting being more closely aligned to an entity's internal risk management practices, however, the Level 1 financial assets and financial liabilities would not be assigned their quoted prices when they are recognised (gross) in the statement of financial position.

 (b) View B would price each individual financial instrument at its corresponding Level 1 price. This view would prioritise the requirement in IFRS 13 that Level 1 inputs should be used without adjustments whenever they are available (see paragraphs 69, 77 and 80 of IFRS 13).

VIEWS A AND C—PORTFOLIO EXCEPTION IS APPLIED

	Quantity held (Q)	Quoted market price (P)	P X Q
Financial assets	10,000		999,500
Financial liabilities	-9,500		950,000
Net long position	**500**	**99**	**49,500**

VIEW B—PORTFOLIO EXCEPTION IS NOT APPLIED

	Quantity held (Q)	Quoted market price (P)	P X Q
Financial assets	10,000	99	990,000
Financial liabilities	-9,500	101	-959,500
			30,500

[9] Although not explicitly mentioned in the letter received, the staff believe that Views A and C (Views 1 and 3 in the letter) would result in the same valuation.

How would such a portfolio have been measured by companies applying US GAAP?

19. IFRS 13 and Topic 820 have the same requirements in relation to the portfolio exception. On the basis of limited outreach performed by the FASB staff, we have learnt that entities applying US GAAP would apply Level 1 prices for the financial assets and financial liabilities of such a portfolio but would then apply a bid-ask spread adjustment depending on the net position.

How would such a portfolio have been measured pre-IFRS 13?

20. IAS 39 and IFRS 9 *Financial Instruments* permitted an entity to take into account the effects of offsetting positions in the same market risk (or risks) when measuring the fair value of a financial asset or financial liability. Many entities were using the same approach for offsetting positions in the credit risk of a particular counterparty by analogy. Paragraph AG72 of IAS 39 is reproduced below **[emphasis added]**:[10]

> 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 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

[10] 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.

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.

Feedback received about practice pre-IFRS 13

21. On the basis of the feedback received from a very limited outreach performed on this matter, paragraph AG72 in IAS 39 has been interpreted as permitting an entity to take into account the effects of offsetting risk positions in the same market risk (or risks) arising from assets and liabilities when measuring the fair value of a net open position.

22. The following example is a numerical illustration of the feedback received above. Assume a portfolio made up of a long position and a short position in the same financial instrument with market quoted prices as follows:

In 'currency units (CU)'	**Bid**	**Mid**	**Ask**
Quoted bid-ask prices	98	100	102

23. Based on the feedback received, when applying IAS 39[11], entities would have obtained the following measurement of the net open position of such a portfolio:

Measuring the net open position			
	Quantity held (Q)	**Quoted market price (P)**	**P x Q**
Financial assets	10,000	100	1,000,000
Financial liabilities	-9,500	100	-950,000
Net long position at mid	**500**	**100**	**50,000**
Bid-ask adjustment			-1,000
Net long position	**500**	**98**	**49,000**

Another way of computing this:

Financial assets	9,500	100	950,000
	500	98	49,000
Financial liabilities	-9,500	100	-950,000
Net long position	**500**	**98**	**49,000**

24. Measuring the individual financial instruments at their quoted market prices would have resulted in the following measurement instead:

[11] The guidance in paragraph AG72 of IAS 39 caused that entities applying IAS 39 used the bid price to measure financial assets held and the ask price to measure financial liabilities held.

Measuring each individual financial instrument			
	Quantity held (Q)	Quoted market price (P)	P x Q
Financial assets	10,000	98	980,000
Financial liabilities	-9,500	102	-969,000
Net long position	**500**		**11,000**

Agenda criteria assessment

25. Our assessment of the Interpretations Committee's agenda criteria is as follows:

(a) *Does the issue has a widespread effect and has, or is expected to have, a material effect on those affected?*

We note that IFRS 13 is effective from 1 January 2013. Consequently, it is still early to assess whether the different possible views on how to apply the portfolio exception could have a widespread effect.

As described in paragraphs 20–24, for portfolios composed of the same quoted financial instruments, practice under IAS 39 or IFRS 9 seems to have been to measure the net open position of such portfolios at P×Q. Our understanding is that the prevalence of portfolios fully made up of Level 1 instruments is, however, lower than other types of portfolios.
We note that, even though there was probably no divergence before the issuance of IFRS 13, now that IFRS 13 has been issued, this may make entities question whether they should continue applying the same practices as they did before it was issued. Consequently, IFRS 13 may cause divergence to increase.

(b) *Would financial reporting be improved through elimination, or reduction, of the diversity?*

IFRS 13 is effective from 1 January 2013. Although, as mentioned above, IFRS 13 may cause divergence to increase, it is still too early to assess whether there is divergence in the application of the portfolio exception.

(c) *Can the issue be resolved efficiently within the confines of existing IFRSs and the* Conceptual Framework for Financial Reporting*?*

We think that the issue can be resolved within the confines of existing IFRSs.

(d) *Can the Interpretations Committee address this issue in an efficient manner?*

We believe that the issue is sufficiently narrow in scope to apply the interpretation process.

(e) *Will the issue be effective for a reasonable period?*

The issue does not relate to a current or planned IASB project and its clarification is related to specific requirements of a recently issued Standard.

Questions for the Interpretations Committee

Questions for the Interpretations Committee
Does the Interpretations Committee think that the guidance in IFRS 13 relating to the interaction between Level 1 instruments and the portfolio exception is sufficiently clear?

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.[12]
- 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

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

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, 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.