IFRS Hot Topic: Impact of Adopting IFRS 9 on the Measurement of Unquoted Equity Investments Previously Carried at Cost under IAS 39

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Purpose of Document

This publication highlights the impact of adopting IFRS 9 *Financial Instruments* on the measurement of certain equity investments in private companies that, under *IAS 39 Financial Instruments: Recognition and Measurements,* were carried at cost but under IFRS 9 would be measured at fair value. It also identifies application guidance released by the International Accounting Standards Board (IASB) on measuring the fair value of unquoted equity instruments.

Why is This Important?

- Since unlisted entities have less access to funds than listed entities, they often make payments in shares and the recipient must account for the investments at fair value.
- Depending on the percentage of shares held, an investor may have limited access to management of the private company and information needed to determine fair value (e.g. financial statements, information on recent share transactions and on-going updates about operations and progress of material projects).
- Fair value will have to be determined on an ongoing basis at each reporting period. Although the transaction price may represent fair value at initial recognition it will become more difficult to justify that it still represents fair value in subsequent periods.
- Valuing unquoted equity instruments is complex and the input of valuation experts would likely be needed to determine fair value for subsequent measurement.

What to do With This Information?

If you are involved in the financial reporting for an entity with investments in unquoted equity instruments which are measured at cost under IAS 39, be aware of the impact of adopting IFRS 9 to consider how fair value will be determined. This may include consulting with a valuation specialist and establishing processes to obtain information from relevant investees in order to measure fair value and provide the IFRS 13 *Fair Value Measurement* disclosure requirements at each reporting period.

Note: While a new exposure draft on amendments to IFRS 9 was issued by the IASB in November 2012, no changes are proposed or being considered to the classification and measurement of equity instruments.

IAS 39 vs IFRS 9

Treatment of Investments in Equity Instruments		
	IAS 39 *(Currently effective)*	**IFRS 9** *(Effective for periods beginning on or after January 1, 2018 – tentative)*
Initial Measurement	Fair value, plus, if not at fair value through profit or loss, directly attributable transaction costs. (Para 43)	Fair value, plus, if not at fair value through profit or loss, directly attributable transaction costs. (Para 5.1)

Subsequent Measurement	Fair value **EXCEPT** where required to be measured at cost because (Para AG80): ▪ there is no quoted market price in an active market; AND ▪ fair value cannot be reliably measured because either: 1. the variability in the range of reasonable fair value estimates is significant. 2. the probabilities of the various estimates within the range cannot be reasonably assessed and used in estimating fair value. Accordingly, further analysis would be required before concluding the investment should be carried at cost. IAS 39.AG81 explains that "in many circumstances", the variability of fair value estimates should not be significant, and that "normally" it is possible to reasonably estimate a fair value for an unquoted equity instrument that was acquired from a third party. Therefore, this exception is usually only applicable, for example, to start-up companies or those involved in exploration and evaluation of resources because of their uncertain circumstances.	Fair value; however, in limited circumstances cost may approximate fair value (Para B5.4.14), for example: ▪ when insufficient more recent information is available to measure fair value. ▪ when there is a wide range of possible fair value measurements and cost represents the best estimate of fair value in the range. Indicators that cost might not be representative of fair value include: ▪ a significant change in the performance of the investee compared with budgets, plans or milestones. ▪ changes in expectation that the investee's technical product milestones will be achieved. ▪ significant change in the market for the investee's equity or its products or potential products. ▪ a significant change in the global economy or the economic environment in which the investee operates. ▪ a significant change in the performance of comparable entities, or in the valuations implied by the overall market. ▪ internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy. ▪ evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties. The above list included in paragraph B5.4.15 is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. For example, where the above factors exist for start-up companies and entities involved in exploration and evaluation of resources, cost may not approximate fair value after initial recognition.

Impact on Measurement:

The limited exception for measuring unquoted equity instruments at cost that existed under IAS 39 is no longer available under IFRS 9; therefore, overall there is a lessened ability to measure unquoted equity instruments at cost.

The impact of this change will particularly affect unquoted equity investments in start-up companies and companies involved in evaluation and exploration of resources where measurement at cost may have been justified in the past as a result of high variability in the range of reasonable fair value estimates and probability of the various estimates were not reasonably assessable. In accordance with IFRS 9, these investments would have to be measured at fair value. While it may be fairly easy to justify that cost approximates fair values at inception, more detailed assessment would be required in subsequent periods to determine if cost still approximates fair value.

Impact on Disclosure Requirements:

<table>
<tr><th colspan="2">Disclosures Relevant to Investments in Equity Instruments</th></tr>
<tr><th>Disclosures applicable to equity investments measured at cost in accordance with IAS 39</th><th>IFRS 13 fair value disclosures applicable to all equity investments once IFRS 9 is adopted</th></tr>
<tr><td>Per IFRS 7 Financial Instruments: Disclosures paragraph 29(b) the IFRS 7.25-28 disclosures on fair value do not apply to unquoted equity instruments measured at cost in accordance with IAS 39.

However, per IFRS 7.30 the following disclosure requirements apply:
▪ The fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably.
▪ A description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably.
▪ Information about the market for the instruments.
▪ Information about whether and how the entity intends to dispose of the financial instruments.</td><td>IFRS 13 Fair Value Measurement will be used to determine fair value when required by IFRS 9. IFRS 13 requires extensive disclosures on recurring level 3 fair value measurements which include unquoted equity instruments.

Key IFRS 13 disclosure requirements include:
▪ Description of the valuation techniques and inputs used in the fair value measurement.
▪ Quantitative information about significant unobservable inputs used in the fair value measurement.
▪ A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.
  • If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.
▪ If changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, that fact and the effect of those changes and how they were calculated.
▪ A description of the valuation processes and policies.

Refer to IFRS 13.91-99 for all applicable IFRS 13 disclosure requirements that will apply once IFRS 9 is adopted.</td></tr>
</table>

The IFRS 7.30 disclosure requirements will not apply once IFRS 9 is adopted since IFRS 9 requires fair value for all equity instruments. In circumstances where the transaction price does not equal fair value at initial recognition (e.g. forced sales, related party transactions, etc.), IFRS 7.28 requires certain disclosures. These disclosures are likely the only IFRS 7 fair value disclosure requirement that will apply since consequential amendments resulting from IFRS 13 deleted most IFRS 7 fair value disclosures.

Guidance for Measuring Fair Value:

The IASB issued educational material which provides guidance on measuring fair value for unquoted equity instruments in accordance with IFRS 13.

Preparers of financial statements are often concerned about the complexity and costs involved in measuring fair value of unquoted equity instruments. IFRS 13.B5 describes the use of transaction prices paid for an identical or similar instrument of an investee (i.e., recent arm's length market transactions between knowledgeable, willing parties) as a valuation technique that may be used to measure fair value. If recent market transactions reflect market expectations, it may be a simple and cost-effective valuation technique to use. Paragraph 28 – 31 and example 2 and 3 in the IASB education material contains additional guidance on this valuation technique.

The following is a summary of valuation techniques and the paragraphs where they are discussed in the IASB educational material:

1. Market approach
    a. Transaction price paid for identical or similar instrument of an investee (Para 28 - 33)
    b. Comparable company valuation multiples (Para 34 - 69)

2. Income approach
    a. Discounted cash flow (DCF) (Para 71 - 114)
    b. Dividend discount model (DDM) (Para 115 - 116)
    c. Constant growth DDM (Para 117 - 121)
    d. Capitalisation model (Para 122 - 124)

3. Adjusted net asset method (Para 125 - 129)

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