

Fair value measurements: the impact for financial instruments

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Introduction

On 30 November 2006, the International Accounting Standards Board (IASB or the Board) issued a Discussion Paper (DP) *Fair Value Measurements*. The DP includes the US GAAP Statement of Financial Accounting Standards (SFAS) 157 *Fair Value Measurements* published in September 2006 and asks a number of questions about the appropriateness of the approach set out in SFAS 157. It sets out those matters on which the IASB does not agree with the FASB, and those in which the IASB believes additional guidance is needed.

The DP includes 27 different questions on which the IASB has requested responses. At its January 2007 meeting, the Board unanimously agreed to extend the original comment letter deadline to 4 May 2007. The IASB also indicated that it will conduct roundtable discussions with constituents following the comment period. The comments received on both the DP and the roundtable discussions will be considered by the Board in developing an exposure draft on fair value measurement, due to be issued in early 2008.

The purpose of SFAS 157 is to provide a common definition of fair value and a framework for its measurement, whenever US GAAP requires assets or liabilities to be recorded at fair value. It does not change the requirements as to when fair value should be used.

The introduction of SFAS 157 into IFRS, without consequential amendments to other IFRS standards, could lead to unintended consequences where the definition of 'fair value' in current IFRS is not the same as defined in SFAS 157. For instance, IAS 39 *Financial Instruments: Recognition and Measurement* requires that assets carried at amortised cost be initially recognised at fair value, but considers the transaction price to be, in many cases, the best indicator of the fair value. If the SFAS 157 definition of fair value is adopted, without further amendment to IAS 39, the initial recognition of amortised cost-based assets at exit prices would often result in the recognition of upfront losses.

The IASB is aware of this issue and has stated that it will review each existing standard to assess whether the intended measurement objective is consistent with the proposed definition.



While SFAS 157 and the DP apply to all assets and liabilities measured at fair value, this newsletter only addresses its implications for the measurement of financial instruments.

SFAS 157 brings US GAAP closer to IAS 39 in several areas (such as introducing the concept of the entity's most advantageous market as a cornerstone for determining fair value) but it differs in a number of important respects (such as the treatment of bid-ask adjustments and 'Day 1' profit (or loss)).

Fair value definition

SFAS 157 defines fair value as the "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." This definition clearly requires the use of an 'exit' price in the determination of fair value and differs from the current definition of fair value in IAS 39, where transaction price (entry price) is presumed to be the best indicator of fair value, unless this presumption can be overcome by reference to observable market prices.

One consequence of the use of exit price to determine fair value is that it allows for the recognition of Day 1 profit (the difference between the transaction price and the exit price) in certain situations, even when the exit price is based on inputs that are unobservable. Focus on an exit price also serves to clarify the objective of determining a fair value in practice. Currently, many financial institutions value financial instruments, such as derivatives, at the value at which they could be fully hedged rather than exited. As such, the introduction of SFAS 157 will not necessarily result in all Day 1 profit being released. Model values will need to be adjusted to reflect the fair value that another market participant would pay or receive to purchase the contract or assume the liability (ie, the exit price), including the risk premium, or dealer spread, that they would charge. As a result, if a financial instrument is acquired from another market participant, the default assumption should be that its initial fair value is equivalent to the transaction price¹.

Another significant concept clarified under SFAS 157 is the idea that the fair value of an asset is measured based on its 'highest and best use'. The highest and best use of an asset will determine whether the asset should be valued on an *in exchange*, stand-alone basis, or *in-use*, in conjunction with other assets as a group. The former will often be more appropriate for financial assets, but the Standard does not prohibit financial assets from being valued on an in-use basis. Fair value on an in-use basis is determined based on the price that would be received in a

transaction to sell the group of assets together. This is important since a financial institution can create value by entering into transactions with offsetting risks so that the portfolio will be worth more than the sum of its parts. This provision in SFAS 157 allows firms to measure certain financial instruments (such as derivatives) as part of a portfolio, in a manner closer to how they are currently valued in practice. IAS 39 does not explicitly permit this approach other than for assets and liabilities with offsetting market risks, in which case mid-market prices are permitted for their valuation. SFAS 157 requires that the resulting value is an exit price, whether an in-exchange or in-use basis is used as the valuation premise.

A majority of the members of the IASB believe that the exit price approach reflects current market-based expectations of flows of economic benefit into or out of the entity. However, several IASB members have concerns over the requirement to base fair values on exit prices, rather than entry prices, and the DP requests feedback from constituents on this issue.

Fair value hierarchy

SFAS 157 establishes a fair value hierarchy to prioritise the inputs used in valuation techniques, with the highest priority given to inputs from observable active markets:

Level 1: observable prices in active markets for identical assets and liabilities.

Level 2: observable inputs other than quoted prices in active markets for identical assets and liabilities, which include inputs that are not directly observable, but that, can be corroborated by market observable inputs.

Level 3: unobservable inputs.

A similar hierarchy already exists in IAS 39 and prioritises the inputs used to measure fair value, based on relative reliability. In SFAS 157 the hierarchy also has consequences for disclosure (see discussion below).

Principal or most advantageous market

SFAS 157 requires fair values to be based on the price that would be achieved to sell an asset or transfer a liability in the 'principal market' or, in its absence, the 'most advantageous market'. The Standard indicates that the principal market is the market in which the entity would sell the asset or transfer the liability with the greatest volume and level of activity. For example, a financial institution would most likely exit a financial instrument in the 'inter-dealer' market, whereas a corporate entity would exit a financial instrument in the retail market.

¹ Reference should be made to the December 2006 Speech by SEC Staff, "Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments," available at www.sec.gov.

Currently, paragraph AG72 of IAS 39 indicates that fair value is determined based on the “most advantageous active market to which the entity has access”, which is similar to SFAS 157.

Transaction costs and bid-risk spread

Transaction costs to sell the asset (eg, commissions) should not be considered in the determination of fair value, although they should be considered when assessing the most advantageous market available to the entity. This is consistent with IAS 39 and the IASB’s belief that transaction costs are attributes of the transaction rather than of the specific asset or liability.

However, the guidance on the treatment of transaction costs appears to conflict with the approach in IAS 39 (and SFAS 157) for the recording of assets at the bid price, and recording liabilities at the offer price (although SFAS 157 takes a more complex approach to this issue than IAS 39 – see discussion below). According to IAS 39, the bid-ask spread represents transaction costs. Requiring the use of bid and ask prices in certain circumstances results in some transaction costs being included in the valuation of financial instruments and some not, depending on how they are traded and the market pricing convention. This apparent confusion needs to be re-examined as part of the development of the ED.

SFAS 157 permits the use of bid prices to measure assets and ask prices to measure liabilities, but specifies the use of the price within the bid-ask spread that is most representative of fair value in the circumstances (ie, where in the spread the entity will exit the position). Market makers in securities, who can expect to trade out of their positions without incurring a bid-ask spread, and who have applied bid or offer adjustments to their holdings under IAS 39, may be able to release a significant portion of the price adjustment.

However, as a ‘practical expedient’, SFAS 157 permits the use of mid-market pricing (and other ‘similar’ pricing conventions) when determining fair value for instruments measured based on bid-ask prices. We understand that the FASB included this approach in order to enable certain types of investment companies (eg, mutual funds) to continue with their current practice of valuing investments using mid-market prices. However, this pragmatic exception, as set out in SFAS 157, is not limited to any specific industry or circumstance, so long as it is applied consistently. This choice will not improve the comparability of financial statements. However, not using the bid or ask for valuation purposes would be consistent with the belief that transaction costs are not deemed an attribute of the financial instrument.

The IASB’s preliminary view agrees with the approach outlined in SFAS 157 with respect to the treatment of the bid-offer spread. However, the IASB has not reached a view on whether: (1) mid-market pricing (and other similar pricing conventions) can be used as a practical expedient, or (2) the guidance should apply only when bid and ask prices are observable in the market, or should also apply to valuations based on Level 2 and Level 3 of the fair value hierarchy.

Liabilities

IAS 39 differs from SFAS 157 in that SFAS 157 requires liabilities to be measured at the value at which the obligation would be ‘transferred’ rather than its ‘settlement’ value. The IASB’s preliminary view is that the transfer price more accurately reflects the IFRS fair value measurement objective, as it represents a market-based approach rather than an entity-specific view that might be included in the settlement value.

SFAS 157 states that the fair value of a liability should reflect ‘non-performance risk’, ie, the risk that a debtor entity is unable to meet its obligations. This will include the entity’s own credit risk, which IAS 39 also requires to be taken into account in determining the fair value of liabilities. SFAS 157 indicates that the fair value measurement of a liability assumes that it is transferred to a market participant at the measurement date and that the non-performance risk relating to the liability is deemed to be the same before and after its transfer. The liability is assumed to be transferred to a hypothetical market participant with the same credit rating. However, because non-performance risk is considered from the perspective of the obligation being measured, as opposed to the credit risk associated with the entity holding the obligation, credit enhancements such as collateral arrangements will impact the fair value of a liability.

Restrictions on sale

In SFAS 157, the effect of a restriction on the sale or use of a financial instrument will depend on whether the market participants would consider such a restriction in pricing the instrument. This means that if the entity is restricted from selling the asset, but other parties would not be, it is not permitted to adjust the price. We find this counter-intuitive since the restriction surely results in the ‘most advantageous market’ for the entity being restricted to (say) the forward market (for settlement after the restriction period has ended). If the restriction is ignored, the instrument may be recorded at a value which is not realisable. Currently, under IAS 39 there is diversity in practice as to when and how discounts for restrictions on sale should be treated. We believe that all restrictions (contractual and statutory) that prevent the sale or transfer of a security should be considered when determining the fair value.

Block discounts

SFAS 157 states that if an active market is available for a financial instrument, then the instrument must be measured within 'Level 1' and no liquidity discount is permitted even if an entity holds a larger position than could be liquidated in the market at the market price. While the same principle is contained in SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*, this will be a change for broker-dealers who have previously followed guidance from the *AICPA Audit Guide* which allowed for the use of block discounts in valuing positions.

The treatment of block discounts is consistent with the guidance contained in paragraphs AG71-AG72 of IAS 39. The IASB continues to believe that liquidity discounts should not be considered when determining the fair value of a large holding. The rationale for this approach in SFAS 157 is that the decision as to whether to sell a large block in one transaction or in smaller parcels is entity-specific and so to permit block discounts would introduce management intent into the measurement, reducing comparability. However, while undoubtedly some blocks of securities can be liquidated in smaller trades at the quoted prices, this will often not be possible; repeated selling, by the normal laws of supply and demand, will depress the price that can be achieved before the whole block can be sold. We continue to believe that it is appropriate to recognise block discounts, as it is intuitive that the entity will not achieve 'price times quantity' for the block, no matter how it disposes of the securities.

When determining the fair value of a financial instrument that is not traded in an active market (ie, Level 2 and Level 3), SFAS 157 requires the liquidity of the instrument to be considered if it affects its price. Note that an entity does not have the option to measure the financial instrument at a lower level in the hierarchy (ie, Level 2 or Level 3) in order to include a liquidity discount in the fair value measurement.

Day 1 profit or loss

SFAS 157 changes the US GAAP rules on the recognition of Day 1 profit, ie, the profit or loss that arises on initial recognition if fair value differs from the transaction price. SFAS 157 effectively repeals footnote 3 of EITF 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* and permits the recognition of Day 1 profit in certain situations, even if the inputs to the valuation technique are Level 3 (ie, unobservable). This decision flows

from the decision to base fair value on exit rather than entry prices. While transaction price (entry price) and exit price may be the same in many instances, US GAAP no longer presumes this to be the case. Additional disclosures are required for profits arising from Level 3-based valuations (see discussion below).

The IASB has not reached a preliminary view in the DP, nor has it specifically requested feedback from constituents on this issue as one of its 27 questions. However, feedback will be indirectly received when constituents respond to the concept of exit price.

It should be noted that under the transition requirements of SFAS 157, any Day 1 profit that has been previously deferred under EITF 02-3 are accounted for as an adjustment to opening retained earnings when SFAS 157 is first adopted, and so will never be credited to the income statement.

Disclosures

SFAS 157 expands the required disclosures about the use of fair value. The disclosure requirements differ depending upon whether the assets and liabilities are subsequently measured at fair value on a recurring basis (eg, trading securities) or a non-recurring basis (eg, impaired assets). For items measured on a recurring basis the following need to be disclosed for each 'major category' of assets and liabilities:

- a) fair value at the reporting date
- b) the Level of the fair value hierarchy in which they 'entirely fall', with
- c) a reconciliation for items measured using Level 3 of the opening and closing fair value, showing:
 - i) total gains or losses
 - ii) net purchases, sales and settlements
 - iii) transfers to and from Level 1 or Level 2, plus
- d) the amount of total gains or losses from Level 3 measurements attributable to changes in the unrealised gain or loss for positions still held at the period end, and
- e) the valuation techniques used, together with details of any changes in techniques.

Note that if the valuation premise is in-use (ie, part of a portfolio) and the asset group is comprised of instruments that fall within different levels of the hierarchy, the value of the asset group would need to be allocated amongst each level of the fair value hierarchy. Application of this disclosure requirement may present a challenge for entities. At a minimum, we believe that the allocation of fair value for a particular financial instrument should be done on a consistent and rational basis.

It also should be noted that SFAS 157 does not require disclosure of the amount of Day 1 profit recorded on the initial recognition of financial instruments, measured using Level 3 inputs, equivalent to the IFRS 7 requirement to disclose the Day 1 profit deferred.

Instead, any Day 1 profit and subsequent revaluation gains and losses for Level 3 measurements will be included in the disclosed changes in unrealised gains and losses for the period.

The IASB has not reached a preliminary view on the disclosures required by SFAS 157 as it intends to consider the current IFRS disclosure requirements when developing an ED.

If you would like to discuss financial instruments in more detail, please contact your regular Ernst & Young representative or one of the people below:

Tony Clifford	London	+44 (0) 20 7951 2250	Mark Seddon	Melbourne	+61 3 8650 7444
Melinda Evans	London	+44 (0) 20 7980 0108	Gianpiero Tedesco	Milan	+39 02 7221 2451
Neville Gray	London	+44 (0) 20 7951 1261	Avet Mirakyan	Moscow	+7 095 938 6667
Jane Hurworth	London	+44 (0) 20 7951 4155	Dmitry Weinstein	Moscow	+7 095 938 6689
Richard Solomon	London	+44 (0) 20 7951 5308	Ken Marshall	New York	+1 212 773 2279
Ian Wilson	London	+44 (0) 20 7951 0282	Tara Kengla	New York	+1 212 773 8828
Michiel van der Lof	Amsterdam	+31 20 546 6030	Bjarne Moller	Oslo	+47 2 400 2860
George de Meris	Amsterdam	+31 20 549 7240	Bernard Heller	Paris	+33 1 46 93 73 68
Bernard Roeders	Amsterdam	+31 20 549 7451	Sophie Ganter	Paris	+33 1 55 61 00 62
Eric Tarleton	Bahrain	+973 1753 5455	Laure Guegan	Paris	+33 1 55 61 08 25
Ashwani Siotia	Bahrain	+973 17 521 676	Michaela Kubyova	Prague	+420 225 335 608
Roland Ruprecht	Bern	+41 58 286 61 87	Leo van der Tas	Rotterdam	+31 10 406 8114
Jean-Francois Hubin	Brussels	+32 2 774 92 66	Wilson Woo	Singapore	+65 6309 6750
Kim Tang Lassen	Copenhagen	+45 3587 2651	Winston Ngan	Singapore	+65 6309 6918
Jesper Slot	Copenhagen	+45 3587 2529	Anna Peyron	Stockholm	+46 8 520 593 81
Claus-Peter Wagner	Frankfurt	+49 6916 996 26512	Steffen Kuhn	Stuttgart	+49 711 9881 14063
Marja Tikka	Helsinki	+358 9 1727 7236	Lynn Kraus	Sydney	+61 2 9248 4244
Päivi Virtanen	Helsinki	+358 9 1727 7533	Joost Hendriks	The Hague	+31 70 3286 430
Keith Pogson	Hong Kong	+852 2849 9227	Mike Modena	Tokyo	+81 3 3503 1791
Thierry Bertrand	Luxembourg	+352 42 124 8845	Ambrogio Virgilio	Turin	+39 01 1516 1611
Bernard Lhoest	Luxembourg	+352 42 124 8315	Piotr Gajek	Warsaw	+48 22 557 7488
José Carlos Hernández	Madrid	+34 91 572 72 28	Pawel Preuss	Warsaw	+48 22 557 7530
Wilson Tan	Manila	+632 894 8127	Andreas Loetscher	Zurich	+41 58 286 42 26
Josephine Abarca	Manila	+632 894 8317	John Alton	Zurich	+41 58 286 42 69

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