

Fair's fair

More focus on telling the fair value story
under the amended IFRS 7



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PRICEWATERHOUSECOOPERS 

More focus on fair value in amended IFRS 7

What's the issue?

Fair value measurement has been hotly debated following the global economic fall out. Reporting financial instruments at fair value has been, and continues to be, the biggest issue for the International Accounting Standards Board (IASB) to contend with.

Views on the issue tend to be polarised.

Proponents argue that reporting fair value merely 'opened the community's eyes' to the high risk business decisions undertaken by many in financial markets and the resulting economic problems before us.

Opponents argue that reporting fair value creates 'pro-cyclicality' in a downturn since assets decrease in value which may trigger fire sales of assets that drive down prices and valuations.

In response to the community's concerns, in March 2009 the IASB amended IFRS 7, '*Financial instruments: Disclosure*' to require entities to disclose more

information about their financial instruments. The amendments aim to give users of financial statements more meaningful information about the valuations and methodologies companies use to help them understand the uncertainty associated with fair value measurement and liquidity risk. The effective date for the amendment is for accounting periods starting on or after 1 January 2009.

This booklet aims to help companies understand the new requirements of IFRS 7 and encourage management to make the most of the opportunity to review and refine their fair value measurement techniques. We expect the new disclosure requirements to be a key area of focus for those charged with governance, such as the audit committee and the board, so it's imperative that management has a clear understanding of the impact of the fair value measures and assumptions for their business. For UK GAAP preparers the amendments are also included in FRS 29, '*Financial instruments: Disclosures*'.

More disclosure under the new fair value hierarchy

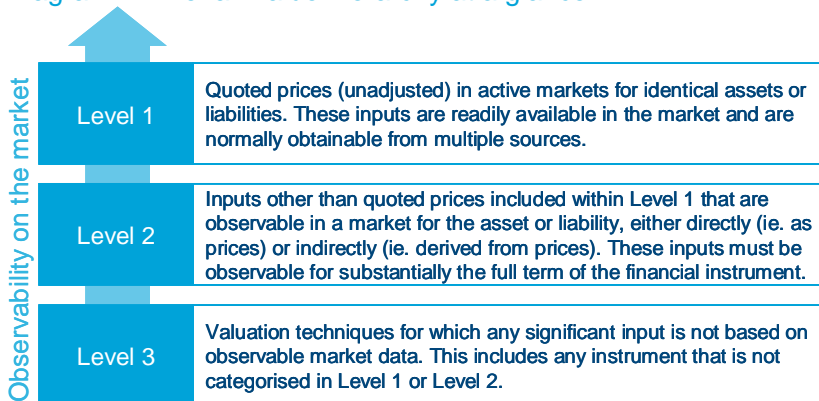
What's the purpose of the new hierarchy?

Under the amended IFRS 7, all financial instruments that are measured at fair value in the balance sheet are required to be classified into a new three-level fair value hierarchy. The levels in the fair value hierarchy drive the disclosures that companies need to make about these types of financial instrument (refer to Diagram 1).

The hierarchy is designed to help users of financial statements understand how the fair value measurement was determined, and the reliability of any estimates or assumptions used.

The hierarchy identifies which estimates and other inputs are observable in the marketplace (and are therefore more objective), versus those that are not observable on the market (and are therefore more subjective). For example, observable inputs include equities listed on the London Stock Exchange, whereas unobservable inputs include unlisted equity investments where the valuation is determined using management's financial forecasts.

Diagram 1: The fair value hierarchy at a glance



What financial instruments do companies commonly measure at fair value?

Listed securities, private equity, interest rate swaps, forward foreign exchange contracts, and warrants.

Classifying financial instruments within the hierarchy

Which financial instruments belong where?

The table below illustrates how financial instruments measured at fair value would typically be classified in the new fair value hierarchy. This table is illustrative only. All companies have different levels of market access, trade frequency and data availability, all of which will affect how their financial instruments are classified in the fair value hierarchy.

	Description of level in the fair value hierarchy	Financial instruments commonly classified in this level	Sources of pricing inputs commonly classified in this level
Level 1	Inputs must be quoted prices in an active market. The quoted prices must be readily and regularly available (usually from an exchange) and the prices must represent actual and regularly occurring market transactions on an arm's length basis.	<ul style="list-style-type: none"> LSE listed equities and other listed equities in active markets. Government bonds that are actively traded. Listed corporate bonds. 	<ul style="list-style-type: none"> Items traded on an exchange or active index/market location (for example, the LSE, NYSE).
Level 2	Inputs that are observable (directly or indirectly) in the market.	<ul style="list-style-type: none"> Certain corporate bonds where interest rate and credit risk inputs are observable. Government bonds that are not actively traded. Some interest rate swaps based on the quoted swap rate. Foreign currency forward contracts where the evaluation is based on observable benchmark data and observed credit spread. Some listed securities that are not traded in an active market. 	<ul style="list-style-type: none"> Quoted prices for similar instruments in active markets. Posted or published clearing prices, if corroborated by observable market data through correlation or by other means (market-corroborated inputs). Broker quotes corroborated by observable market data. Dealer quotes for non-liquid securities provided the dealer is standing ready and able to transact. Most inputs, other than quoted prices that are observable on the market (for example, interest rates, yield curves observable at commonly quoted intervals).
Level 3	Inputs that are not observable in the market, which may include information that is derived through extrapolation and which is not corroborated by observable market data. Level 3 inputs generally reflect the entity's own assumptions about how a market participant would reasonably be expected to determine the price of a financial instrument.	<ul style="list-style-type: none"> Some long-dated interest rate options. Some long-dated foreign currency derivatives. Unlisted equity investments where the valuation is determined using management's financial forecasts. Long-dated corporate bonds with few contributors to consensus pricing. Listed securities where the market is inactive (where the quoted price isn't current, little information is publicly available, price quotations vary substantially over time or among market makers, or management's assumptions are used). Most long-dated energy derivatives. 	<ul style="list-style-type: none"> Inputs from broker quotes that are indicative (ie. not transacted upon) or not corroborated by observable market data. Models incorporating management's assumptions, which are not corroborated by observable market data.

The disclosures required under the hierarchy

What new information does my business have to disclose?

In addition to disclosing the level of the financial instrument in the fair value hierarchy, companies are also required to disclose the following information for each class of financial instruments:

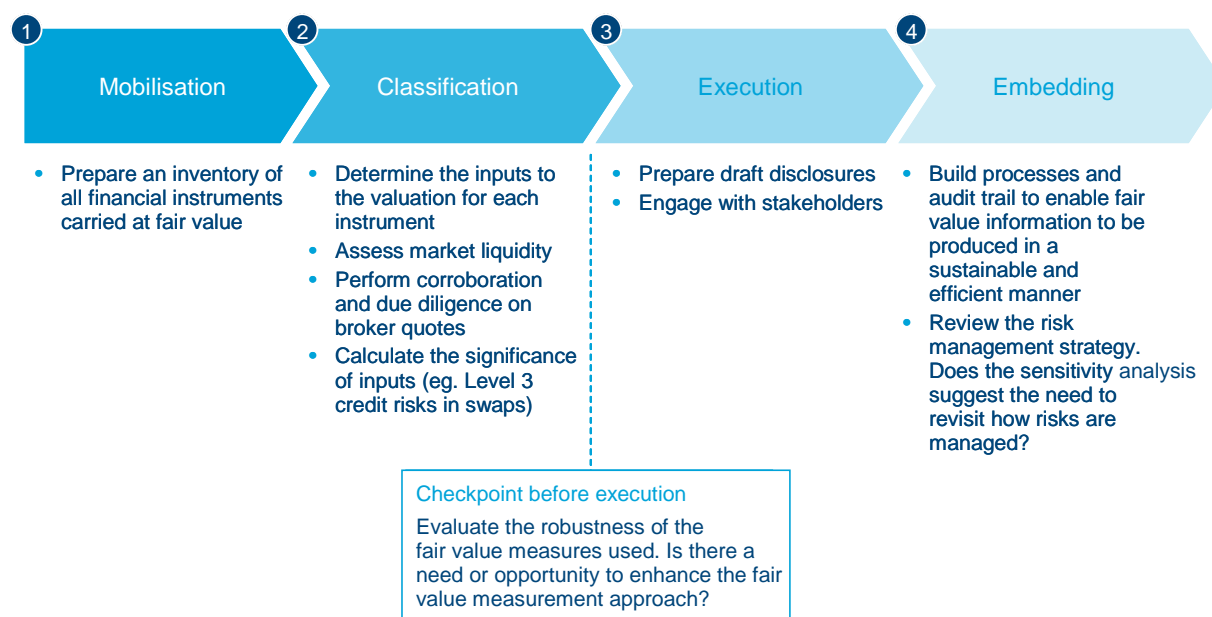
- Any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers.
- The accounting policy for recognising the difference (if any) at transaction date between the transaction price and the fair value of the financial instrument using a valuation technique ('day one profit or loss').
- Key assumptions and estimates (for example, relating to pre-payment rates, rates of estimated credit losses, interest rates, or discount rates).
- Where fair value measurements are within the Level 3 category of the hierarchy:
 - A reconciliation between the opening balance to the final balance.
 - If the fair value would change significantly by changing one or more inputs to reasonably possible alternative assumptions, companies are required to disclose that fact, the effect of those changes, and how the effect was calculated.

The amendment also clarifies and enhances existing requirements for the disclosure of liquidity risk. It primarily requires a separate liquidity risk analysis for derivative and non-derivative financial liabilities. Disclosure of the contractual maturities for derivatives is required only if an understanding of the contractual maturities is essential to the reader's understanding.

Implementing the amendments to IFRS 7

How should my business transition?

The effective date for the amendment is for accounting periods starting on or after 1 January 2009, with no comparatives for the first year of application. However, the new requirements require a reconciliation of the movements between the opening and closing balances of items classified as level 3 within the fair value hierarchy. In order to be able to perform this reconciliation, the classification of instruments held on the first day of the annual period in which this amendment is effective will be required – for example, 1 January 2009 for 31 December 2009 year ends.





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The new disclosure requirements will inevitably lead many to review and refine their fair value measurement techniques.

A key focus point for those charged with governance, such as the audit committee and the board, is a clear understanding of the impact of the fair value measures and assumptions

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Determining the appropriate level in the fair value hierarchy

Question. The valuation of the fair value of my company's financial instruments includes observable market information for a similar instrument and our own assumptions. Can we classify the financial instrument in the Level 2 category?

Answer. Not necessarily. If the valuation technique uses inputs from multiple levels of the fair value hierarchy, the lowest level of significant input determines the level of the entire fair value measurement in the hierarchy. Determining the significance of a particular input to a fair value measurement is a matter of judgement but a good starting point is to assess the quantitative impact of that input on the fair value measure.

For example, an entity holds a 20-year corporate bond. When determining the fair value of the bond, the entity's inputs are a 10-year yield curve (Level 2 input) and an extrapolated curve for the remaining term (Level 3 input). The Level 3 input is significant to the fair value measurement; therefore, the corporate bond is classified as Level 3 in the fair value hierarchy.

Question. My company has a listed equity security measured at fair value. Can we classify it in the Level 1 category?

Answer. Not necessarily. The determination of whether inputs are observable on the market is only one of the key factors that will impact the classification of the financial instrument within the hierarchy. The level of activity in the market will contribute to the determination of whether an input is observable. For example, prices may be observable on the market, but a requirement to adjust prices due to a lack of liquidity may cause a financial instrument that would otherwise have been classified in the Level 1 category to be classified in the Level 2 category.

For example, although an AIM-listed security is generally classified as Level 1, in a scenario where trading activity is low and prices are not updated on a daily basis, an AIM security is likely to be classified as Level 2. Non-active instruments listed on an exchange (for example, privately held debt, albeit with a listing in Jersey) are likely to be Level 2 or Level 3.

Question. My company obtained a broker quote for an unlisted corporate bond. Can we classify the corporate bond in the Level 2 category?

Answer. Not necessarily. Information provided by these sources could fall within Level 2 or Level 3, depending on the source of the information for a particular financial instrument.

Entities will need to understand how the pricing information has been developed in order to determine the fair value hierarchy classification. Without additional supporting information (such as multiple broker quotes), prices obtained from a single broker or pricing service are indicative values or proxy quotes, and typically represent Level 3 inputs.

Question. Will the new fair value hierarchy affect my company's valuation techniques?

Answer. No. The fair value hierarchy only drives the disclosure requirements of financial instruments measured at fair value; it does not affect a company's valuation techniques.

Selecting the appropriate valuation technique should be based on the assessment of the facts and circumstances specific to the financial instrument being measured. It is a process that is independent of the financial instrument's classification within the fair value hierarchy.

Understanding the enhanced disclosures for liquidity risk

The amendments to IFRS 7 further clarify the required disclosures for liquidity risk, primarily in relation to the maturity analysis of derivative instruments, guarantees and financial assets.

Question. What new liquidity risk disclosures are required for derivative financial liabilities?

Answer. Entities are required to prepare a maturity analysis for all derivative financial liabilities. The maturity analysis is required to include disclosure of the remaining contractual maturity of these liabilities where it is needed to give stakeholders an understanding of the timing of the expected cash flows.

This will be the case for interest rate swaps in a cash flow hedge of a variable rate financial asset or liability, but not for all derivatives. For example, contractual maturities are not essential for an understanding of derivatives in a trading portfolio which are expected to be settled before maturity on a net basis. Therefore, disclosure of fair values of such derivatives on an expected maturity basis is acceptable.

Question. Should financial guarantees be included in my company's maturity analysis?

Answer. Yes. The maximum amount of the guarantee or loan commitment should be disclosed in the earliest time period that it can be called upon.

For example, if a parent entity guarantees a subsidiary's £1m bank debt, the parent entity should disclose the £1m in the maturity analysis in the earliest time period, regardless of whether the guarantee is likely to be called upon.

Question. When is my company required to prepare a maturity analysis for financial assets?

Answer. A maturity analysis is required if a company holds financial assets for managing liquidity risk, and information about those financial assets is necessary in order for users of the financial statements to evaluate the nature and extent of the company's liquidity risk.

For example, this will typically be the case for financial institutions, such as banks and insurance companies, and companies with significant trading activities, such as energy companies.

Question. My company is exposed to collateral calls. Do we have to disclose this?

Answer. Yes, because collateral requirements on financial instruments can pose a significant liquidity risk.

For example, an entity with a derivative liability may be required to post cash collateral on the derivative if the liability exceeds certain limits. As a result, if collateral calls expose the entity to significant liquidity risk, the entity should provide quantitative disclosures of their collateral arrangements as those cash flows could occur earlier than the contractual maturity. Whenever an entity is subject to collateral calls, additional qualitative disclosures are recommended, including a description of how the entity is exposed to collateral calls on financial instruments and how that risk is managed.

Appendix: Case study

The disclosures below are extracts from the IFRS 7 requirements. A comprehensive illustration of the disclosure requirements is included in *Illustrative IFRS corporate consolidated financial statements for 2009 year-ends* (available from www.pwc.com/ifrs).

Applying the IFRS 7 amendments in practice

Determining the fair value hierarchy

As of 1 January 2009, Entity A has adopted the IFRS 7 amendments, which require disclosure of how the following fair value measurements fit within the fair value measurement hierarchy:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1).
- Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (Level 2).
- Inputs for the asset or liability that are not based on observable market data (Level 3).

Entity A's financial instruments that are measured and recognised at fair value include:

- Financial assets at fair value through profit or loss (forward foreign exchange contracts)
- Derivatives used for hedging (interest rate swaps)
- Available-for-sale financial assets (LSE-listed shares and unlisted equity investments)
- Available-for-sale debt securities (unlisted corporate bonds)
- Financial liabilities, including derivatives used for hedging (interest rate swaps).

The following table presents Entity's A financial assets and liabilities measured at fair value at 31 December 2009.

Types of assets/liabilities	Level 1	Level 2	Level 3	Total balance
Assets				
Financial assets at fair value through profit or loss	-	-	115	115
Derivatives used for hedging	-	350	-	350
Available-for-sale equity securities	425		215	640
Available-for-sale debt securities	-	100	-	100
Total assets	425	450	330	1,205
Liabilities				
Derivatives used for hedging	-	327	-	327
Total liabilities	-	327	-	327

Level 1 financial instruments

The fair value of financial instruments traded in active markets (such as available-for-sale securities traded on the LSE) is based on quoted market prices at the balance sheet date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used by Entity A is the current bid price.

Level 2 financial instruments

The fair values of financial instruments that are not traded in an active market (interest rate swaps and available-for-sale debt) are determined by using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity-specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in level 2.

Quoted market prices or dealer quotes for similar instruments are used to estimate the fair value of available-for-sale debt instruments for disclosure purposes.

The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows based on observable yield curves. In cases where a valuation technique for these instruments is based on one or more significant unobservable inputs, such instruments are included in Level 3.

Level 3 financial instruments

The fair value of forward foreign exchange contracts is determined using the present value of the estimated future cash flows based on market rates at the end of the reporting period.

In 2009, the group transferred a held-for-trading forward foreign exchange contract from Level 2 into Level 3. The reason for doing so was because the counterparty for the derivative encountered significant financial difficulties, which resulted in a significant increase to the discount rate due to increased counterparty credit risk that is not based on observable inputs.

Unlisted equity investments are also included in Level 3. The fair value of these instruments is determined using a price earnings ratio.

The following table presents the changes in Level 3 instruments for the year ended 31 December 2009.

	Trading derivatives at fair value through profit or loss	Available-for-sale equity securities
Opening balance	-	210
Transfers into level 3	119	-
Gains / (losses) recognised in profit or loss	(4)	5
Closing balance	115	215
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	(4)	5

Liquidity risk disclosures

The table below analyses Entity B's non-derivative financial liabilities and net-settled derivative financial liabilities into relevant maturity groupings based on the remaining period at the balance sheet to the contractual maturity date. Derivative financial liabilities are included in the analysis if their contractual maturities are essential for an understanding of the timing of the cash flows. The amounts disclosed in the table are the contractual undiscounted cash flows. Balances due within 12 months equal their carrying balances as the impact of discounting is insignificant.

At 31 December 2009	Less than 1 year	Between 1 and 2 years	Between 2 and 5 years	More than 5 years
Borrowings (ex finance lease liabilities)	20,496	22,002	67,457	38,050
Finance lease liabilities	2,749	1,573	4,719	2,063
Trade and other payables	15,668	-	-	-
Financial guarantee contracts	21	-	-	-
Derivative financial instruments (net settled)	280	10	116	41
Derivative financial instrument (gross settled)				
Forward foreign exchange contracts – cash flow hedges				
Outflow	15,073	9,168	-	-
Inflow	15,189	9,567	-	-

At 31 December 2008	Less than 1 year	Between 1 and 2 years	Between 2 and 5 years	More than 5 years
Borrowings (ex finance lease liabilities)	16,258	11,575	58,679	38,103
Finance lease liabilities	3,203	1,790	5,370	2,891
Trade and other payables	11,518	-	-	-
Financial guarantee contracts	10	-	-	-
Derivative financial instruments (net settled)	317	15	81	50
Derivative financial instruments (gross settled)				
Forward foreign exchange contracts – cash flow hedges				
Outflow	15,921	9,156	-	-
Inflow	15,893	9,473	-	-

Of the 67,457 disclosed in the 2009 'Borrowings' time band 'Between 2 and 5 years', Entity B intends to repay 40,000 in the first quarter of 2010 (2008: nil).

Entity B's trading portfolio of derivative instruments with a negative fair value have been included in the liquidity risk table at their fair value of 268 (2008: 298) within the less-than-one-year time bucket. This is because the contractual maturities are not essential for an understanding of the timing of the cash flows. These contracts are managed on a net-fair value basis rather than by maturity date.

How PricewaterhouseCoopers can help

For more information, please contact your regular PricewaterhouseCoopers representative or one of the following contacts in the Corporate Treasury Group to discuss how we can help you with your IFRS 7 issues.

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Other relevant IFRS publications

To access materials on other financial reporting issues, please contact your PricewaterhouseCoopers representative.

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