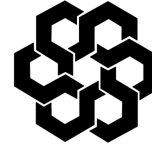

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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **16 November 2006, London**

Project: **Financial Instruments – Due Process Document (DPD)**

Subject: **Recognition and Measurement (Agenda Paper 5A)**

CONTENTS OF PAPER

1. This paper considers the following issues:

    a. Reliability of fair value measurement

    b. Unit of account for recognition

    c. Initial measurement of items in the scope of the DPD

    d. Unit of measurement

IS FAIR VALUE RELIABLY MEASURABLE FOR ALL ITEMS IN THE DPD SCOPE?

2. Whether **all** financial instruments and related items can be measured with sufficient reliability to be used in financial statements at a reasonable cost has always been a significant point of debate amongst constituents. For example,

around 80% of respondents of the Joint Working Group's report, *Financial Instruments and Similar Items,* disagreed that fair values of **all** financial instruments can be measured with sufficient reliability. However, others stated that "fair value computations can be made for virtually all financial instruments at a reasonable cost" [Reference omitted].

3. That was in 2001. Valuation techniques continue to advance (although new and more complex financial instruments have also since been developed). In addition, further accounting guidance has been issued since 2001, including FASB Statement No. 157, *Fair Value Measurements.*

4. The Boards may wish to consider whether it is possible to measure, with sufficient reliability and at a reasonable cost, the fair value of investments in some unquoted equity instruments (and contracts that are linked to, and must be settled with the delivery of, such an instrument) as well as certain long-dated derivatives.

5. Reasons for making exceptions to fair value measurement may include the extent of internal information and assumptions required to make a fair value measurement (with limited available information being publicly available, especially in "start-up" situations or for derivatives with terms that go far beyond the period for which market information is available), and the costs that may be incurred in producing fair value measurements of such instruments on a regular basis.

6. The Boards may also wish to consider multiple element contracts that also include sets of contractual but non-financial rights and obligations[1]. Under the DPD, the set of financial rights and obligations of such a contract would be separately accounted for and measured at fair value, with the difference between the fair value of the whole contract being attributed to the remaining non-financial rights and obligations.

[1] An example is a contract that contains (a) a promise by which party A will construct a building for party B in return for later payment (a non-financial component), and (b) a promise whereby party A agrees to lend money to party B so that party B can purchase fixtures and fittings from someone else (this would be a financial component).

7. The Boards may believe that it may sometimes be **practically** difficult to identify and measure the separate sets of financial and non-financial rights and obligations. If so, then the DPD could require that the entity account for the entire contract in accordance with the requirements of the DPD.

8. If the Boards decide that fair value cannot be measured with sufficient reliability at a reasonable cost under certain circumstances, the staff suggests that the DPD sets out those circumstances (rather then listing specific instrument types). The Boards would also need to set out the accounting treatment required when sufficiently reliable fair value measurements become either available or unavailable.

9. **Questions to the Boards:**

    a. **Is the measurement of the fair values of all items in the scope of the DPD sufficiently reliable and not too costly for use in the financial statements?**

    b. **If fair values cannot always be measured with sufficient reliability, under what circumstances would that occur?**

    c. **If you are not prepared to answer those questions, what additional information do you need?**

UNIT OF ACCOUNT FOR RECOGNITION

10. This paper considers the following possible units of account for recognition purposes:

    a. A portion of an individual instrument

    b. The individual instrument

    c. A ‘linked’ (synthetic instrument) approach involving two or more instruments

A portion of an individual instrument

11. Historically, we have often required bifurcation of a single element contract to achieve a particular measurement objective (for example, to measure an embedded derivative at fair value). If a single measurement attribute is used for all financial instruments in the scope of the DPD, then this reason would not be relevant with regard to financial instruments.

12. In the Insurance project, the IASB has tentatively decided that an insurer shall unbundle the insurance, deposit, and service components of an insurance contract unless the components are so interdependent that they can only be measured on an arbitrary basis. Such unbundling of components is for recognition and measurement purposes.

13. However, by requiring such unbundling (where possible), users of financial statements are arguably also able to better understand how the performance obligation of the insurance company is being discharged.

14. That is, another possible reason to permit or require bifurcation of a contract might be for display purposes; to provide decision useful information to the users of financial statements.

The individual instrument

15. The Boards could decide that the appropriate unit of account for recognition is each individual instrument. This is the most practical and straight-forward approach and results in representing "real world" phenomena.

A 'linked' approach (synthetic instrument) involving two or more instruments

16. Another alternative would be to require recognition using a *linked* approach that involves linking two or more related instruments and recognizing them as a single asset or liability. A *linked* approach seeks to achieve consistent accounting for financial instruments, whether they are included in a single contract or in two or

more contracts. In the past, this approach has been called synthetic instrument accounting.

17. However, if a single measurement attribute is used for all items in the scope of the DPD, then, similarly to the previous discussion on bifurcation, a *linked* approach is not required.

18. There may be display related issues that would result in a *linked* approach to recognition providing more decision useful information (for example, to allow users to understand the effect of two or more related instruments). However, a *linked* approach to unit of account would require setting out criteria under which linkage would be required. Such criteria will inevitably be somewhat arbitrary which may reduce or eliminate any benefits to be gained under such an approach. Furthermore, requiring a linked approach to the unit of account will increase, not decrease, the complexity of accounting for financial instruments.

19. **Questions to the Boards:**

    a. Do the Boards wish to take a preliminary view as to the unit of account for financial instruments? If so, what is that preliminary view?

    b. **If you are not prepared to answer this question, what additional information do you need?**

INITIAL MEASUREMENT

20. The DPD needs to consider how a newly acquired or assumed financial instrument should be measured.

21. It is worth noting, however, that **if** initial gains and losses (if any) are reported in the same line in the income statement as subsequent gains and losses, then this question becomes largely irrelevant.

22. The Boards have three choices as to how a financial instrument should be initially measured:

    a. Fair value (market exit value)

    b. Transaction price

    c. Market entry value (analogous to fair value, but based on prices in entry markets instead of exit markets)

23. If a financial instrument is initially measured at fair value, then any difference between the fair value and the transaction price would be recognized as a gain or loss on acquisition or assumption of the item.

24. If a financial instrument is measured at the transaction price on initial recognition, then any gain or loss arising from a difference between the fair value on remeasurement of the item and the transaction price could be recognized immediately after acquisition or assumption. (An alternative approach would be to amortize any difference to profit or loss over some period, although such an approach (a) would result in recognizing a deferred "what-you-may-call-it" or measuring the financial instrument at something other than fair value, and hence (b) would not be consistent with the long-term objective of requiring that all financial instruments be measured at fair value with realized and unrealized gains and losses recognized in the period in which they occur.)

25. A market entry value would be the same as the transaction price if the transaction is at arms length and neither party is compelled to transact. This would result in the same considerations as set out in the previous paragraph regarding the treatment of any gain or loss arising from a difference between the fair value on remeasurement of the item and the entry (or transaction) price on acquisition or assumption of the item.

26. Given the requirements of Statement No. 157, the FASB Board members may believe that the DPD should require all financial instruments to be measured at fair value on initial measurement.

27. However, the IASB has yet to reach a preliminary view on whether it is appropriate to use a measurement on initial recognition that includes inputs that are not directly observable in a market if that measurement differs from the transaction price. The Invitation to Comment for the IASB's Fair Value Measurements discussion paper includes a question to respondents on this issue. In order not to prejudge any decision by the IASB on this issue, IASB Board members may believe that the DPD should set out whatever the position of the IASB is on this issue at the time of issuing the DPD.

28. The staff also notes that the same question arises in other projects–notably in the modified joint Insurance project being led by the IASB as well as the joint Revenue Recognition project. To the extent that different conclusions are reached (or being reached) in the different projects, the DPD should seek to explain why.

29. **Questions to the Boards:**

    a. **How should financial instruments be measured at initial recognition?**

    b. **If you are not prepared to answer this question, what additional information do you need?**

UNIT OF MEASUREMENT

30. The unit of measurement determines the level at which the recognized asset or liability is aggregated for measurement.

31. This paper considers the following possible units of measurement for items in the scope of the DPD:

    a. The individual instrument

b. A portfolio of instruments.

32. In many circumstances there may be no difference between using different units of measurement (for example, financial instruments traded in deep and liquid markets).

The individual instrument

33. The Boards could decide that the appropriate unit of measurement is each individual instrument. This would be consistent with current literature regarding the measurement of portfolios of identical instruments traded in an active market (see below).

34. Such an approach would result in all entities measuring financial instruments using a common unit of measurement.

35. However, this approach would be inconsistent with the preliminary views of the IASB Board in the Insurance project (see below). It may also be neither the most practicable approach nor provide the most decision useful information to the users of financial statements in all situations.

Portfolios of instruments

36. This paper considers three different types of portfolios (there may be other types as well):

    a. Portfolios (or 'blocks') of identical financial instruments traded in an active market (for example, common stock of Citigroup)

    b. Portfolios of non-identical financial instruments that share broadly similar risks (for example, loans with interest rate, credit and prepayment risk)

    c. Portfolios of non-identical financial instruments with offsetting separately identifiable risks (for example, certain options and other derivative instruments–where a separately identifiable risk in one instrument in the

portfolio may offset the same identifiable risk in another instrument in the portfolio–and the portfolio is therefore measured and managed on the basis of the net position in each separately identifiable risk).

Blocks of Identical Financial Instruments Traded in Active Markets

37. Existing guidance on fair value measurement of blocks of identical instruments traded in an active market does not permit any adjustment for the quantity of instruments held in an entity's portfolio and the quantity exchanged in observable transactions (normal market size). Such an adjustment is often referred to as a *blockage factor*. *Blockage factors* are not been permitted because adjusting the observable price for the size of the position introduces management intent (that is, to trade in blocks) into the measurement and hence reduces the reliability and comparability (and hence relevance) of reported estimates of fair value[2].

38. Adjusting the value of a portfolio to reflect possible benefits arising from a *control premium* raise many similar issues. A *control premium* adjustment would seek to reflect the benefits an investor might gain as a result of the influence over an entity arising from, for example, the voting rights attached to the portfolio of shares held[3].

39. However, a *control premium* is different than a *blockage factor*. A *blockage factor* is primarily concerned with the relative liquidity between an individual instrument and a block of identical instruments. A *blockage factor* could either be a discount or premium to the price for the individual instrument.

40. Permitting a *control premium* adjustment for portfolios of identical financial instruments would, however, raise the same issues as for *blockage factor* adjustments.

[2] Paragraphs C72 to C80 of Statement No. 157 discuss these issues in detail. For the convenience of Board members, those paragraphs are reproduced in the Appendix.
[3] The scope of the DPD already excludes investments in consolidated subsidiaries, consolidated variable interest entities (FASB only), and associates (equity method investees in FASB terms) or joint ventures.

Non-identical Financial Instruments with Similar Risk Exposures

41. Portfolios of non-identical financial instruments that share broadly similar risks (such as interest rate, credit and prepayment risk) are often measured and managed together.

42. As previously noted, in an efficient market there may be no significant measurement effect from measuring an item individually or as part of a portfolio. Putting aside the issue of adverse selection (also called *moral hazard*), then arguably the U.S. residential mortgage market is an example of an efficient market; the same statistical data will be used to measure an individual contract as would be used to measure a portfolio. However, some markets are inefficient and there may be portfolio measurement effects.

43. The staff also notes that often an entity would only transfer portfolios of such instruments (as opposed to individual instruments)[4] – for reasons including that of adverse selection associated with the transfer of individual contracts (and the associated pricing implications for individual contracts). Possibly, the market in which actual transactions involving the transfers of such instruments are observed should be considered in determining the appropriate unit of measurement.

44. The IASB, in the Insurance project, has tentatively decided that risk margins should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio. Such a decision is arguably based on practical considerations as opposed to any conceptual considerations.

[4] The most probable outcome for instruments in such portfolios is often that the instrument will be settled with the original counterparty. However, Statement 157 is clear that fair value is a *transfer* and not a *settlement* notion. This is also consistent with the IASB's preliminary views that the term *transfer* more accurately describes the fair value measurement objective already in IFRSs.

Non-identical Financial Instruments with Offsetting Risks

45. Similar considerations might appear to apply to portfolios of non-identical financial instruments with offsetting separately identifiable risks (for example, certain options and other derivative instruments).

46. There is, however, at least one difference in the way that such portfolios are measured and managed. The portfolio might be measured on the basis of the separately identifiable risks held by the entity rather than on the basis of the fair values of the individual instruments. The portfolio is then managed by the exposure created for the net position in each separately identifiable risk.

47. Furthermore, typically the instruments within such a portfolio could contain both assets and liabilities. This obviously raises the issue of offset between assets and liabilities.

48. Allowing a portfolio unit of measurement in such a portfolio would result in measuring the separately identifiable risks, rather than measuring the in-exchange fair values of the contracts themselves.

49. Another issue is the uniqueness of such portfolios. Instruments in portfolios that share broadly similar risks (as previously discussed) typically form part of an asset class that is relatively homogeneous. However, portfolios of non-identical financial instruments that contain separately identifiable risks that offset each other to some extent are probably unique to the entity. Sales of such portfolios rarely occur. It is difficult to see how a fair value that represents a hypothetical transaction at the portfolio level might be achieved for a portfolio that contains risk positions unique to that entity and where the risk appetites of other market participants are probably not well known.

Defining the unit of measurement

50. In summary, the staff believes that it is difficult to clearly define what should, or should not, be included in a portfolio for accounting measurement purposes -

beyond setting some broad criteria (such as a portfolio in which all the instruments are subject to 'broadly similar risks' and all the instruments are managed together).

51. Instead, the decision primarily revolves around which approach (a) is practicable, and (b) provides users with the most decision useful information.

52. **Questions to the Boards:**

    a. **Do the Boards wish to give a preliminary view on the required unit of measurement for financial instruments? If so, what is that preliminary view?**

    b. **If you are not prepared to answer this question, what additional information do you need?**

Appendix – extract from Statement No. 157 *Fair Value Measurements*

C72. In other FASB Statements (including Statements 107 and 133, and FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*), the Board decided that for a block, the fair value measurement should be based on the individual trading unit, determined using P×Q. Therefore, those Statements preclude the use of a blockage factor, even if the normal trading volume for one day is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

C73. Paragraph 58 of Statement 107 states:

> Although many respondents to the 1990 and 1987 Exposure Drafts agreed with the usefulness of disclosing quoted market prices derived from active markets, some argued that quoted prices from thin markets do not provide relevant measures of fair value, particularly when an entity holds a large amount of a thinly traded financial instrument that could not be absorbed by the market in a single transaction. The Board considered this issue and reiterated its belief that quoted prices, even from thin markets, provide useful information because investors and creditors regularly rely on those prices to make their decisions. The Board noted that providing the liquidation value of a block of financial instruments is not the objective of this Statement. The Board also concluded that requiring the use of available quoted market prices would increase the comparability of the disclosures among entities.

C74. Similarly, paragraph 315 of Statement 133 states:

> The definition of fair value requires that fair value be determined as the product of the number of trading units of an asset times a quoted market price if available [as required by Statement 107]. . . . Some respondents to the Exposure Draft indicated that the guidance in Statement 107 (and implicitly the definition of *fair value* in this Statement) should be revised to require or permit consideration of a discount in valuing a large asset position. They asserted that an entity that holds a relatively large amount (compared with average trading volume) of a traded asset and

> liquidates the entire amount at one time likely would receive an amount less than the quoted market price. Although respondents generally focused on a discount, holding a relatively large amount of an asset might sometimes result in a premium over the market price for a single trading unit. The Board currently believes that the use of a blockage factor would lessen the reliability and comparability of reported estimates of fair value.

C75. For broker-dealers and certain investment companies (investment companies other than registered funds subject to SEC reporting requirements that used blockage factors in financial statements for fiscal years ending on or before May 31, 2000), the AICPA Audit and Accounting Guides for those industries allowed an exception to the requirement of other FASB pronouncements to use P×Q to measure the fair value of a block. Specifically, the Guides permitted a fair value measurement using a blockage factor, where appropriate.

C76. In developing this Statement, the Board decided to address that inconsistency within GAAP. The Board considered the earlier work completed by AcSEC through its Blockage Factor Task Force, which was formed in 2000 to address issues specific to the use of blockage factors (discounts) by broker-dealers and investment companies. Based on its discussions with industry representatives (broker-dealers, mutual funds, and other investment companies) and a review of relevant academic research and market data, the task force affirmed that discounts involving large blocks exist, generally increasing as the size of the block to be traded (expressed as a percentage of the daily trading volume) increases but that the methods for measuring the blockage factors (discounts) vary among entities and are largely subjective.

C77. In the Exposure Draft, the Board acknowledged the diversity in practice with respect to the methods for measuring blockage factors (discounts). However, the Board

agreed that for entities that regularly buy and sell securities in blocks, the financial reporting that would result when using P×Q to measure the fair value of a block position would not be representationally faithful of the underlying business activities. In particular, if a block is purchased at a discount to the quoted price, a fair value measurement using P×Q would give the appearance of a gain upon buying the block, followed by a reported loss on subsequently selling the block (at a discount to the quoted price). At that time, the Board understood that for blocks held by broker-dealers, industry practice was to also sell the securities in blocks. In view of that selling practice (in blocks), the Board decided that this Statement should allow the exception to P×Q in the Guides to continue, thereby permitting the use of blockage factors by broker-dealers and certain investment companies that buy or sell securities in blocks.

C78. Many respondents, in particular, broker-dealers, agreed with that decision. However, during its redeliberations, the Board discussed the need for expanded disclosures about blocks measured using blockage factors with representative preparers (broker-dealers) and users (analysts that follow broker-dealers). Through those discussions, the Board learned that for blocks held by broker-dealers, industry practice is often to sell the securities in multiple transactions involving quantities that might be large but that are not necessarily blocks; that is, the securities could be sold at the quoted price for an individual trading unit. Because of that selling practice, the majority of the Board decided that there was no compelling reason to allow the exception to P×Q in the Guides to continue under this Statement, noting that revised IAS 39 includes similar guidance in paragraph AG72, which states that "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."

C79. In reaching that decision, the majority of the Board affirmed its conclusions relating to the prohibition on the use of blockage factors in other FASB Statements. In particular, the Board emphasized that when a quoted price in an active market for a security is available, that price should be used to measure fair value without regard to an entity's intent to transact at that price. Basing the fair value on the quoted price results in comparable reporting. Adjusting the price for the size of the position introduces management intent (to trade in blocks) into the measurement, reducing comparability. Following the reasoning used in Statement 107, the quoted price provides useful information because investors regularly rely on quoted prices for decision making. Also, the decision to exchange a large position in a single transaction at a price lower than the price that would be available if the position were to be exchanged in multiple transactions (in smaller quantities) is a decision whose consequences should be reported when that decision is executed. Until that transaction occurs, the entity that holds the block has the ability to effect the transaction either in the block market or in another market (the principal or more advantageous market for the individual trading unit).

C80. This Statement precludes the use of blockage factors and eliminates the exception to P×Q in the Guides for a financial instrument that trades in an active market (within Level 1). In other words, the unit of account for an instrument that trades in an active market is the individual trading unit. This Statement amends Statements 107, 115, 124, 133, and 140 to remove the similar unit-of-account guidance in those accounting pronouncements, which referred to a fair value measurement using P×Q for an instrument that trades in any market, including a market that is not active, for example, a thin market (within Level 2). In this Statement, the Board decided not to specify the unit of account

for an instrument that trades in a market that is not active. The Board plans to address unit-of-account issues broadly in its conceptual framework project.