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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**22 January 2009, London**
Project:	**Improving Disclosures about Financial Instruments (proposed amendments to IFRS 7)**
Subject:	**Proposed amendments on fair value disclosures – addendum (Addendum to Agenda paper 14A)**

Purpose of this paper

1 This paper presents an alternative view to the recommendation in paragraph 22 in Agenda Paper 14A, ie not to go forward with the proposed three-level fair value disclosure hierarchy.

Background

2 When preparing the proposals for the exposure draft, the staff presented to the Board five possible ways of approaching the amendments (see Agenda Paper 2B from the September 2008 meeting). (Those approaches included some of those listed in paragraph 19 of Agenda Paper 14A.)

a **Option 1**: introduce the FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) fair value hierarchy into both IFRS 7 and IAS 39 *Financial Instruments: Recognition and Measurement*.

b **Option 2**: introduce the SFAS 157 fair value hierarchy into IFRS 7 only.

c **Option 3**: use the existing fair value hierarchy in IAS 39, which represents what some entities are doing in practice to comply with IFRS 7's disclosure requirements and IAS 39's hierarchy.

d **Option 4**: make no changes to IFRS 7 with regard to a hierarchy, but specify which instruments (or types of instruments) require more disclosure.

e **Option 5**: make no changes to IFRS 7. Instead, entities could use material from the disclosure section of the expert advisory panel document, which summarises the disclosures users of financial statements would find helpful, in addition to those required in IFRS 7.

3 The exposure draft reflected Option 3.

Alternative view

4 I disagree with the recommendation in paragraph 22 of Agenda Paper 14A for the following reasons:

a Some financial institutions are already applying a three-level hierarchy that is generally consistent with SFAS 157 in practice. The fair value measurement team's research about the disclosures of 9 of the largest banks in Europe applying IFRS 7 shows that 8 of those banks are using a three-level hierarchy. The hierarchies being used seem to be generally consistent with SFAS 157, but are not exactly the same as SFAS 157. Furthermore, the hierarchies are not always entirely consistent across entities. I understand that:

i some preparers find it difficult to apply a three-level hierarchy when IAS 39 seems to have two (or three or five) levels. If 8 of the 9 largest banks in Europe are able to apply a three-level hierarchy that is consistent with both SFAS 157 and IAS 39, it seems that it is in fact possible (and not difficult) to do. Furthermore, SFAS 157 does not provide a direct mapping of a measurement hierarchy to a disclosure hierarchy. SFAS 157, like IAS 39, states that a valuation technique should maximise the use of observable inputs and minimise the use of unobservable inputs. Once the fair value measurements are determined, those measurements are then analysed for the significance of the inputs used, and that analysis determines where within the hierarchy the asset or liability is categorised for disclosure purposes. I see no difference between IAS 39/IFRS 7 and SFAS 157 in this regard.

ii some users are concerned that the proposed hierarchy is not the same as that in SFAS 157. It seems that having a consistent, three-level hierarchy, whether or not it is exactly the same as SFAS 157, would help users because at least it would increase consistency across entities applying IFRS 7.

b The disclosures made by the 8 banks using a three-level hierarchy are not always in a single place for users to find and analyse. The recommendation to use a tabular format is likely to be helpful to users.

c Some have suggested that entities following the Expert Advisory Panel report might decide to use a three-level hierarchy and that perhaps the Board can recommend that entities do so. I caution against not pursuing the proposals in the IFRS 7 exposure draft on the basis of the Expert Advisory Panel report for two reasons: (i) the Expert Advisory Panel report is a summary of practice, which is noted above not to always be consistent and (ii) that report is educational, not mandatory. As a result, it would not achieve consistency with either SFAS 157 or across entities applying IFRS 7.

d The concerns about the relationship between day one profits or losses and Level 2 of the hierarchy seem to be a non-issue, mainly for the reasons described in (b) above. An entity can measure fair value using observable or unobservable inputs. My view is that where within the hierarchy the measurement is categorised is a separate issue. Instruments measured using solely observable data will be in Levels 1 or 2. Some instruments in Level 2 will not qualify for day one profit or loss recognition (per IAS 39.AG76) because a Level 2 measurement can contain a Level 3 input if that Level 3 input is not significant to the measurement. I would anticipate that not all Level 1 or 2 measurements relate to instruments acquired during the reporting period for which a day one profit or loss is recognised. In that situation, an entity would need to describe which portion of its Level 1 and Level 2 measurements resulted in a day one profit or loss anyway, given that there is unlikely to be a direct mapping between the amounts disclosed by level in the hierarchy and the day one profit or loss disclosure requirements in paragraph 28 of IFRS 7.

Alternative staff recommendation

5 For the above reasons, I think the Board should reaffirm its proposal to include an explicit three-level hierarchy in IFRS 7. That hierarchy should be exactly the same as that in SFAS 157. This would require clarification of paragraph BC5 of the exposure draft in that it is not similar, it is the same. Although this is an interim measure until the fair value measurement standard becomes effective, it provides useful information about an entity's fair value measurements, particularly in the current market environment.

6 If the Board decides to proceed with requiring disclosure by a three-level hierarchy, some of the wording would need to be revisited to ensure that we do not inadvertently change the measurement requirements in IAS 39 to conform with disclosure requirements of SFAS 157 (eg IAS 39 includes in its Level 1 equivalent quoted rates, whereas SFAS 157 includes only quoted prices). The amendments should state that financial instruments (a) are measured using the guidance in IAS 39 (which are unchanged by these amendments) and (b) are disclosed based on the IFRS 7 hierarchy. Any final amendments should be clear that there is no direct link between the categories used in IAS 39 for measurement purposes (eg when determining when adjustments to observed prices are required and for day one gain or loss recognition) and the categories for disclosure (eg although swaps with quoted rates are in 'Level 1' of IAS 39, they would be in Level 2 for disclosure purposes). This is no different from the approach taken in SFAS 157. This means that judgement is needed regarding the assessment of the significance of any input, as is the case with SFAS 157. The exposure draft provided guidance about how significance is to be judged.