Project	**Fair value measurement**
Topic	**Measuring the fair value of a group of financial assets and financial liabilities**

Purpose of this paper

1. This paper addresses the proposal to permit an exception to fair value measurement requirements for measuring the fair value of a group of financial assets and financial liabilities that are managed on the basis of the entity's net exposure to a particular market risk (or risks) (ie interest rate risk, currency risk or other price risk) or to the credit risk of a particular counterparty.

2. This paper asks the boards:

   (a) to clarify particular aspects of the proposal, such as:

      (i) what it means to 'manage' on the basis of the entity's net exposure to market or credit risk;

      (ii) when it is appropriate for an entity to apply the exception to its net exposure to credit risk (eg only when there is a master netting agreement in place or when there are any mitigating arrangements with the counterparty); and

      (iii) that the calculation of credit adjustments takes into account different maturities and tenors (remaining contract period);

   (b) what it means that market risks are 'substantially the same'; and

(c) whether to require a particular method of allocation of bid-ask and credit adjustments to the unit of account specified in the financial instruments standards.

3. This paper does not:

(a) ask the boards to reconsider their decision to permit an exception to fair value measurement requirements for measuring the fair value of a group of financial assets and financial liabilities managed in the way described in this paper; or

(b) address the presentation of financial instruments. The boards are addressing the presentation of financial instruments in other projects.

4. This paper contains the following appendices:

(a) Appendix 1—the proposed guidance for measuring the fair value of financial instruments in the FASB's exposure draft.

(b) Appendix 2—the background information and basis for conclusions in the FASB's exposure draft (please note: the rationale in the FASB's basis for conclusions is consistent with the rationale in the IASB's comprehensive project summary posted to the IASB website in June 2010).

Summary of the proposals

5. The FASB's exposure draft of a proposed Accounting Standards Update (ASU) *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* permits an exception to fair value measurement requirements for measuring the fair value of a group of financial assets and financial liabilities that are managed on the basis of an entity's *net*

exposure to a particular market risk (or risks) (ie interest rate risk, currency risk or other price risk) or to the credit risk of a particular counterparty.[1]

6. When using the exception to measure the fair value of financial instruments managed on the basis of an entity's net exposure to a particular **market risk**, the entity applies the price within the bid-ask spread that is most representative of fair value in the circumstances to the *net position* (rather than to each individual instrument comprising the position).

7. When using the exception to measure the fair value of financial instruments entered into with a particular counterparty, the entity includes the effect of its net exposure to the **credit risk** of that particular counterparty when there is a legally enforceable right to set off one or more financial assets and financial liabilities with the counterparty in the event of default (eg because the entity has entered into a master netting agreement with the counterparty). If the entity is in a net pay position, it applies an adjustment to the net position (rather than to each individual instrument comprising the position) on the basis of its *own* credit risk. If the entity is in a net receive position, it applies an adjustment to the net position on the basis of the *counterparty's* credit risk.

8. An entity is permitted to use the exception when it:

   (a) manages the group of financial assets and financial liabilities on the basis of its net risk exposure in accordance with the entity's documented risk management or investment strategy;

   (b) provides information on that basis about the group of financial assets and financial liabilities to management (eg the entity's board of directors or chief executive officer);

   (c) manages the net risk exposure in a consistent manner from period to period; and

[1] The proposal is identical to the IASB staff draft of a forthcoming IFRS on fair value measurement posted on the IASB website in August 2010.

(d) measures the financial assets and financial liabilities at fair value in the statement of financial position at each reporting date.

9. The proposal applies to financial instruments and derivatives accounted for in accordance with:

    (a) US GAAP: Topic 815 *Derivatives and Hedging* or Topic 825 *Financial Instruments*.

    (b) IFRSs: IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*.

10. If there is a Level 1 input within the group of financial assets and financial liabilities, an entity must use that price without adjustment.

11. The exception applies to measurement, not to financial statement presentation. Entities must comply with the presentation requirements specified in other standards (which in some cases means allocating the net amount to individual financial assets and liabilities).

12. The boards concluded that the proposal is an exception to the fair value measurement requirements because:

    (a) some entities typically do not manage their exposure to market risks and credit risk by selling a financial asset or transferring a financial liability (eg by unwinding a transaction). Rather, they manage their risk exposure by entering into a transaction for another financial instrument (or instruments) that would result in an offsetting position in the same risk.

    (b) the resulting measurement represents the fair value of the net risk exposure, not of an individual financial instrument. The sum of the fair values of the individual instruments is not equal to the fair value of the net risk exposure.

    (c) an entity's net risk exposure is a function of the other financial instruments held by the entity and of the entity's risk preferences (both of which are entity-specific decisions and, thus, do not form part of a fair value measurement). Market participants might hold different groups of financial instruments or might have different risk preferences, and it is those factors that are taken into account when measuring fair value. However, the boards understand that market participants holding that particular group of financial instruments and with those particular risk preferences would be likely to price those financial instruments in the same way (that is, using the same valuation techniques and the same market data). As a result, the measurement of those financial instruments within that particular group is a market-based measurement.

13. However, the boards agreed to permit the exception because, without the exception, the guidance for measuring the fair value of financial instruments, including those that are managed on the basis of an entity's net risk exposure, in some cases does not clearly articulate the relationship between an entity's business strategy and the fair value measurement of financial instruments that are managed on the basis of the entity's net risk exposure.

14. In addition, the exception addresses the practical difficulties that would be faced by entities that have many thousands of individual financial instrument contracts. In particular, measuring fair value on an individual instrument basis would:

    (a) significantly change practice with respect to how entities measure the fair value of financial instruments held within a portfolio;

    (b) require systems changes to effect a change in practice, resulting in significant operational challenges and costs; and

    (c) result in financial reporting being divorced from risk management systems, with the associated implications.

Overview of comments received

15. The Questions for Respondents accompanying the FASB's exposure draft asked interested parties whether they think the proposed guidance is appropriate and whether they think the application of the proposals would change the fair value measurements of such assets and liabilities.

16. Many respondents agreed with the proposal. Financial institutions (and representatives of financial institutions) stated that the proposed guidance is consistent with how they manage financial instruments and is consistent with how they currently measure the fair value of such instruments. This was true for entities applying IFRSs or US GAAP.

17. A few respondents suggest that the exception be extended to financial assets and financial liabilities that do not have offsetting risks but that are held within a portfolio. For example, homogeneous loans that are currently measured at fair value using the in-use valuation premise under Topic 820 *Fair Value Measurements and Disclosures*.[2]

18. A few respondents think of the proposal as a change to the unit of account or an acknowledgement that the unit of valuation can differ from the unit of account, rather than as an exception to fair value measurement requirements.

19. A few respondents would prefer that the boards not allow an exception because it is inconsistent with the objective of a fair value measurement and is in conflict with the unit of account for financial instruments. They are concerned about the implications when an entity's financial assets and financial liabilities exactly offset one another, resulting in a zero net risk exposure. They would rather that the boards require each of the instruments to be measured on a gross basis, with qualitative information about the entity's risk management practices being disclosed.

[2] Although respondents raised this issue in the context of the valuation of financial instruments, it is not the subject of this paper. The staff thinks the fair value measurement guidance already addresses such concerns through the definition of market participants (knowledgeable, willing and able) and the concept of value maximisation.

20. Some respondents are concerned that there will be a lack of consistency and comparability if the criteria for using the exception (see paragraph 8 above) of the proposals are not clarified. For example:

    (a) they would like to have further guidance on what it means to 'manage' financial instruments on the basis of the entity's net exposure to market or credit risks (including whether the exception is limited to financial institutions); and

    (b) they wonder why the instruments must be measured at fair value on a recurring basis and recognised at fair value in the statement of financial position to be able to use the exception.

21. Others raised questions about how to apply the proposed guidance. For example:

    (a) whether there are limitations on the types of financial assets and liabilities that can be in a 'portfolio' (eg could an entity include a quoted interest rate futures contract and a debt instrument with the same benchmark interest rate in the same portfolio?);

    (b) what is meant by market risks being 'substantially the same' (eg could an entity group all instruments with the London Interbank Offered Rate [LIBOR] exposure in one portfolio, or would the grouping need to be done on the basis of exposure to 3-month Eurodollar LIBOR in one portfolio, and 6-month Eurodollar LIBOR in another portfolio?);

    (c) whether only legal rights of offset (eg master netting agreements) can be taken into account when determining the exposure to counterparty credit risk or whether other mitigating arrangements (eg collateral, security, legal-isolation agreements, etc.) can also be taken into account when market participants would do so when pricing the net position;

    (d) whether the adjustment for credit risk should take into account different tenors or maturities (eg Party A owes Party B $100 in 3 months and Party B owes Party A $100 in 1 year). They think the proposed guidance as written is too prescriptive and implies that the credit adjustment in this case would be zero;

(e) how to allocate the bid-ask and credit adjustments to the individual financial assets and financial liabilities, either for presentation or disclosure; and

(f) the relationship between the portfolio exception and the guidance on blockage factors (eg can an entity make an adjustment for the size of the net position if that position is significantly larger or smaller than those typically represented by market participant transactions?).[3]

Staff analysis

22. The proposal for measuring the fair value of financial instruments managed on the basis of an entity's net exposure to market or credit risks was developed because financial institutions and others who manage financial instruments in this way were concerned that measuring the fair value at the unit of account specified in the financial instrument standards (the individual instrument) would require significant systems changes and is not consistent with how they manage and exit financial instruments.

23. The proposal is the result of consultations with financial institutions and auditors of such entities about how financial instruments are managed in practice and how fair value is currently being measured in IFRSs and US GAAP.

[3] Given the boards' decision on blockage factors (see agenda paper 2C (IASB) / 20 (FASB)), some have asked whether size can never be taken into account in a measurement when the size (eg notional amount) of an instrument is much smaller or larger than the size of instruments that are traded in the marketplace. For example, assume an entity holds a 3-year single currency fixed-for-floating rate interest rate swap with a notional amount $1 billion. There is a market for 3-year single currency fixed-for-floating rate interest rate swaps with notional amounts less than $10 million. In this case, the staff thinks size is a characteristic of the asset or liability (and is consistent with the unit of account for financial instruments), not a characteristic of the transaction and, as a result, would be factored into the measurement. The staff thinks Topic 820 currently addresses this situation. Agenda paper 2C (IASB) / 20 (FASB) discusses blocks of financial instruments.

24. Many financial institutions noted in their comment letters that the proposal accurately describes the way they manage and measure financial instruments. The staff thinks that to the extent that the proposed guidance is not consistent with how an entity manages its financial instruments, that entity would not be permitted to use the exception and would be required to measure the fair value of its financial instruments at the individual instrument level (for those instruments not managed on the basis of the entity's net risk exposure). Similarly, if a financial institution does not manage particular financial instruments on the basis of the entity's net risk exposure, that entity would not be permitted to measure their fair value on a net basis.

25. This is why the boards concluded that the entity must:

    (a) have evidence that the entity manages its financial instruments in this way by:

        (i) having a documented risk management or investment strategy; and

        (ii) providing information about the net risk exposure resulting from the financial instruments to management;

    (b) measure these financial instruments at fair value in the statement of financial position. If an instrument is not measured at fair value in the statement of financial position, it is not evident that the entity is managing the instruments on the basis of the entity's net exposure to market or credit risk; and

    (c) manage the net exposure in a consistent manner from period to period (ie an entity must make an accounting policy decision to use the exception. An entity cannot choose to use the exception in one period and not the next, and must use a consistent technique to assess its net exposure from one period to the next).

26. The remainder of this section analyses:

    (a) whether there are limitations on the types of financial instruments that can be in a portfolio;

(b) what is meant by market risks being ‘substantially the same’;

(c) what types of mitigating arrangements can be taken into account when calculating an adjustment for counterparty credit risk;

(d) whether the adjustment for counterparty credit risk takes into account different tenors (remaining contract periods) and maturities; and

(e) whether to provide guidance for allocating bid-ask and credit adjustments to the unit of account specified for financial instruments.

Are there limitations on the types of financial assets and financial liabilities that can be in a portfolio?

27. The proposal does not limit the type of financial instruments that can be grouped and measured on a net basis (as long as the instruments are measured at fair value on a recurring basis). For example, the guidance would apply to a portfolio that includes a quoted interest rate futures contract (a Level 1 instrument) and a debt instrument with the same benchmark interest rate that is measured at fair value.[4]

28. However, the proposal states that if there is a Level 1 instrument within the portfolio, the entity must use that quoted price without adjustment (although the entity would determine the point within the bid-ask spread that best represents fair value in the circumstances). Some respondents think this is redundant to the guidance about the fair value hierarchy and potentially conflicts with the exception because it is the price for an individual instrument.

29. The staff thinks this aspect of the proposal is an important reminder that the fair value of a Level 1 instrument would not differ because that instrument is grouped with other financial instruments in a portfolio. The exception was

[4] The proposed guidance would not apply to groupings of financial and non-financial assets and liabilities within a portfolio. For example, an entity could not create a portfolio of power plants and energy derivatives and measure the fair value of those assets and liabilities on a net basis.

intended to address the unit of account for particular financial instruments, not the use of the fair value hierarchy.

What is meant by 'substantially the same'?

30. The proposal states that the market risks to which the entity is exposed must be substantially the same, but does not describe what 'substantially the same' means. The guidance was intentionally written this way because different entities are exposed to different risks and manage them in different ways.

31. Some respondents have suggested using the risk types used in IFRSs and US GAAP with respect to financial instruments, for example (credit risk is discussed separately below):

    (a) interest rate risk,

    (b) foreign exchange rate risk, and

    (c) other price risk.

32. The staff thinks those risk type categories are too broad.[5] For example, an entity should not be allowed to use the exception to measure the fair value of its exposure to interest rate risk generally. It would not be appropriate for an entity to group all instruments that expose the entity to interest rate risk and apply the bid-ask spread guidance to the net exposure to all interest rate risk. Rather, an entity should separately analyse its exposure to interest rate risk when the instruments have referenced, for example, LIBOR.

33. Even exposure to LIBOR is too broad a category. The staff believes it would not be appropriate to group, say, 1-month Eurodollar LIBOR instruments with 1-year Eurodollar LIBOR instruments because they expose the entity to different underlying risks and have different maturities.

[5] During the outreach performed in developing the FASB's exposure draft and the IASB's staff draft, we heard that financial institutions use thousands of risk categories to manage risk at the most discrete level possible.

34. However, we do not want to narrow it too far. Not all entities manage risk in the same way. For example, assume Entity A manages its exposure to 1-year Eurodollar LIBOR by only grouping instruments that reference 1-year Eurodollar LIBOR. In contrast, Entity B manages its exposure to 1-year Eurodollar LIBOR with a portfolio made up of a 1-month Eurodollar LIBOR instrument, a 1-year Eurodollar LIBOR instrument and a forward contract to purchase an 11-month Eurodollar LIBOR instrument in 1 month.

35. The staff thinks the boards did not intend to preclude Entity B from using the exception with respect to its exposure to 1-year Eurodollar LIBOR.

36. Furthermore, the staff thinks the boards did not intend to require that the instruments must be *exactly* the same. For example, an interest rate swap with a 10-year maturity might reasonably be offset by an interest rate swap with a 9-year and 8 month maturity (as long as both instruments have the same underlying rate and currency).

37. The staff thinks the requirement that market risks be substantially the same is sufficient. Narrowing the requirement further so that market risks must be exactly the same would render the exception unworkable for many financial instruments.

38. In addition, even if the requirement were narrowed so that market risks must be exactly the same, entities are able to use mid-market pricing as a practical expedient when measuring the fair value of each individual asset or liability. As a result, the fair value of the net position would equal the sum of the fair values of each individual instrument measured using the mid-price. However, doing this would in many cases overstate or understate the fair value of an entity's financial instruments because this assumes that the entity could exit the position (and each instrument) at the mid price, which is not typically where many financial institutions exit.

39. The staff thinks concerns about the grouping of instruments by risk component can be mitigated by providing examples of what 'substantially the same' means. For example, the wording could be improved to indicate that it is acceptable for

an entity to have a portfolio that comprises instruments that reference US dollar LIBOR or the US bank prime rate, but not a portfolio that combines both.

Which mitigating arrangements can be taken into account when calculating the credit adjustment?

40. The proposal states that there must be a legally enforceable right to set off one or more financial instruments with the counterparty in the event of default (eg because the entity has entered into a master netting agreement with that counterparty) for an entity to apply an adjustment for credit risk on a net basis. This is consistent with the requirements for offsetting in IAS 32 *Financial Instruments: Presentation* and Topic 210 *Balance Sheet*.[6]

41. Some respondents have asked whether the assessment of an entity's net exposure to credit risk is limited to master netting agreements or if other mitigating arrangements (such as collateral agreements, security, legal-isolation agreements) can be taken into account when market participants would do so when pricing the net position (when there is a reasonable basis for doing so, such as when such offsets have been upheld in previous transactions with that counterparty or in that jurisdiction).

42. The offsetting criteria in Topic 210 allow consideration of any mitigating arrangements that are legally enforceable (although such arrangements are not the only factor in determining whether a legal right of set off exists). The offsetting criteria in IAS 32 would not be met because of the existence of collateral agreements.

43. Current practice with respect to measuring the fair value of financial instruments in IFRSs and US GAAP is to take into account master netting agreements and/or other mitigating arrangements. Such practice is consistent with Basel II requirements.

[6] Topic 210 and Topic 815 codified FASB Interpretation No. 39 *Offsetting of Amounts Related to Certain Contracts*.

44. It is also important to remember that the fair value measurement standard will be applied globally. Limiting the use of the exception with respect to credit risk to those covered by master netting agreements, which might not be legally enforceable in some jurisdictions, may penalise entities who use equally valid alternative arrangements to mitigate their exposure to credit risk.

Does the credit adjustment take into account different tenors and maturities?

45. The proposal states that if the entity owes the counterparty, the credit adjustment should be made on the basis of the entity's own credit risk. Conversely, if the counterparty owes the entity, the adjustment should be made on the basis of the counterparty's credit risk. The adjustment is referred to in practice as a 'credit valuation adjustment', or CVA.

46. The objective of the credit adjustment is to reflect the possibility that the counterparty or the entity might default, and the parties might not receive the full fair value of the transactions. The credit adjustment is calculated at a legal entity level for each counterparty for which the legal entity has exposure to the credit risk of that particular counterparty.

47. Some respondents suggest that the wording of the proposal be excluded from the final standard because it is too prescriptive and implies that the credit adjustment takes into account two factors: (a) the amount owed and (b) the credit risk of the party that owes it, without giving regard to the life of the potential exposure. In many cases, the credit adjustment is calculated by assessing the probability of default of either party and the expected loss given default of the party, and applying a simulation methodology to calculate the expected exposure over the life of the potential exposure. These amounts are then aggregated across a portfolio of transactions with a counterparty to arrive at an expected overall exposure.

48. The staff thinks the wording in the proposal conveys the objective of the credit adjustment. We think it is important to make it clear that the adjustment should reflect the credit risk of the party who owes the liability. However, the staff

thinks the wording could be improved by referring to the life of the potential exposure to credit risk, without stipulating how the credit adjustment should be calculated in a fair value measurement.

How should the bid-ask and credit adjustments be allocated to the unit of account?

49. If the unit of account is not the net position, an entity will need to allocate the bid-ask and credit adjustments to the unit of account, which will typically be the individual financial instrument. As noted above, the exception relates to measurement, not to financial statement presentation. This is a bigger issue for entities applying IFRSs than for those applying US GAAP.

50. IFRSs and US GAAP currently do not have guidance about acceptable methods for allocating these adjustments, and when developing the proposal, the boards agreed not to provide such guidance.

51. The staff understands that there are different ways of allocating the adjustments in practice. For example, some common methodologies include:

    (a) on a relative fair value basis to individual instruments or classes of instruments;

    (b) net the entire bid-ask or credit adjustment against assets if the net position is an asset position, and against liabilities if the net position is a liability position; and

    (c) on the basis of the marginal amount that each asset or liability contributes to the total bid-ask or credit adjustment.

52. The staff notes that financial institutions in some parts of the world (eg in the UK) are disclosing the amounts of the credit adjustments in their financial statements and providing a description of the methodologies used to calculate the adjustments.

53. The staff thinks it is not necessary to prescribe a methodology for allocating bid-ask and credit adjustments because the allocation will depend on factors such as the size of the adjustment relative to the size of the position (materiality).

Instead, the staff thinks the fair value measurement standard should state that the allocation needs to be done on a reasonable and consistent basis.

Staff recommendation

54. The staff recommends the following:

    (a) require that the exception can be applied to financial instruments that are managed on the basis of the entity's net exposure to a particular market risk or risk or to the credit risk of a particular counterparty. Evidence that the entity manages its financial instruments in this way includes:

        (i) having a documented risk management or investment strategy; and

        (ii) providing information about the entity's net risk exposure resulting from the financial instruments to management.

    (b) require that the exception can be applied only to financial instruments measured at fair value in the statement of financial position, and not to financial instruments that are not measured at fair value in the statement of financial position, but for which fair value is required to be disclosed.

    (c) require that an entity must make an accounting policy decision to use the exception and that the exception be applied consistently from period-to-period (ie an entity cannot choose to use the exception in one period and not the next, and must use a consistent technique to assess its net exposure from one period to the next).

    (d) [applicable if the boards agree with the recommendation in paragraph 54(c)] if an entity makes an accounting policy decision to use the exception, require that the entity disclose that fact.

(e) require that when there is a Level 1 instrument within the portfolio, an entity must use that quoted price without adjustment, even when the exception is used.

(f) require that the market risks that are being offset must be substantially the same (and provide an example of this).

(g) clarify that a fair value measurement using the exception should reflect arrangements that mitigate credit risk exposure when such arrangements are legally enforceable (eg master netting agreements or collateral arrangements).

(h) clarify that the calculation of the credit adjustment should take into account the life of the potential exposure to credit risk (ie the different tenors and maturities of the instruments).

(i) not to require a particular method of allocation of the bid-ask and credit adjustments to the unit of account, but require that such allocations should be done on a reasonable, non-arbitrary and consistent basis.

Question 1
Do the boards agree with the staff recommendations in paragraph 54? If not, what do you propose and why?

Appendix 1—Proposed guidance

Application to Financial Instruments

820-10-35-18F Paragraphs 820-10-35-18G through 35-18N describe the fair value measurement of financial assets and financial liabilities (and derivatives that the reporting entity is required to or has elected to measure at fair value in accordance with the guidance in Topic 815 or Topic 825).

Inputs Based on Bid and Ask Prices

820-10-35-18G If an input used to measure fair value (see paragraphs 820-10-35-36 through 35-36D) has a bid price and an ask price (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value regardless of where the input is categorized within the fair value hierarchy (that is, Level 1, 2, or 3; see paragraphs 820-10-35-37 through 35-54A). The use of bid prices for long positions (assets) and ask prices for short positions (liabilities) is permitted but not required.

820-10-35-18H This Topic does not preclude the use of mid-market pricing or other pricing conventions used by market participants as a practical expedient for fair value measurements within a bid-ask spread.

Measuring the Fair Value of Financial Assets and Financial Liabilities When a Reporting Entity Has Offsetting Positions in Market Risks or Counterparty Credit Risk

820-10-35-18I A reporting entity that holds a group of financial assets and financial liabilities is exposed to market risks (that is, interest rate risk, currency risk, or other price risk) and to the credit risk of each of the counterparties. When the reporting entity manages that group of financial assets and financial liabilities on the basis of its net exposure to either of those risks, the reporting entity is permitted to apply an exception to the requirements in this Topic for measuring fair value. That exception permits a reporting entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk exposure or to transfer a net short position (that is, a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date.

820-10-35-18J A reporting entity is permitted to use that exception if the reporting entity does all of the following:

a. Manages the group of financial assets and financial liabilities on the basis of the reporting entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the reporting entity's documented risk management or investment strategy

b. Provides information on that basis about the group of financial assets and financial liabilities to the reporting entity's management (for example, the reporting entity's board of directors or chief executive officer)
c. Manages the net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in a consistent manner from period to period
d. Is required to or has elected to measure the financial assets and financial liabilities at fair value in the statement of financial position at each reporting date.

820-10-35-18K When using the exception in paragraph 820-10-35-18I to measure the fair value of a group of financial assets and financial liabilities managed on the basis of the reporting entity's net exposure to a particular market risk (or risks), the reporting entity shall apply the price within the bid-ask spread that is most representative of fair value in the circumstances to the reporting entity's net exposure to those market risks. When that exception is applied to measure the fair value of a group of financial assets and financial liabilities, the market risks that are being offset shall be substantially the same.

820-10-35-18L When using the exception in paragraph 820-10-35-18I to measure the fair value of a group of financial assets and financial liabilities entered into with a particular counterparty, the reporting entity shall include the effect of the reporting entity's net exposure to the credit risk of that counterparty in the fair value measurement when there is a legally enforceable right to set off one or more financial assets and financial liabilities with the counterparty in the event of default (for example, because the reporting entity has entered into a master netting agreement with that counterparty). If the reporting entity has a net short position (that is, the reporting entity owes the counterparty), the reporting entity shall apply such an adjustment on the basis of its own credit risk. If the reporting entity has a net long position (that is, the counterparty owes the reporting entity), the reporting entity shall apply an adjustment on the basis of the counterparty's credit risk.

820-10-35-18M If there is a quoted price in an active market (that is, a Level 1 input) for a financial asset or a financial liability within a group of financial assets and financial liabilities, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C [paragraph 35-41C provides limited circumstances for adjusting a Level 1 input].

820-10-35-18N The exception in paragraph 820-10-35-18I does not apply to financial statement presentation. A reporting entity shall comply with the financial statement presentation requirements specified in other Topics.

Appendix 2—Background information and basis for conclusions

BC21. A reporting entity that holds a group of financial assets and financial liabilities is exposed to market risks (that is, interest rate risk, currency risk, or other price risk) and to the credit risk of each of the counterparties. Financial institutions and similar reporting entities in the United States and internationally that hold financial assets and financial liabilities often manage those instruments on the basis of the reporting entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty. Therefore, the Boards believe it is important that U.S. GAAP and IFRSs have the same requirements for measuring the fair value of financial instruments.

BC22. The guidance in U.S. GAAP and IFRSs for measuring the fair value of financial instruments is articulated differently. In U.S. GAAP, many reporting entities currently apply the in-use valuation premise when measuring the fair value of financial assets and financial liabilities that have offsetting positions in a particular market risk (or risks) or in the credit risk of a particular counterparty when those risks are managed on the basis of the reporting entity's net exposure to either of those risks. That is, a reporting entity takes into account how the fair value of each financial asset or financial liability might be affected by the combination of that asset or liability with other financial assets or financial liabilities held by the reporting entity.

BC23. Other reporting entities apply the in-exchange valuation premise to the reporting entity's net risk exposure and assume that the transaction is for the net position, not for the individual assets and liabilities comprising that position. Those differing applications of the valuation premise arose because the guidance in Topic 820 does not specify the valuation premise for financial assets.

BC24. In IFRSs, reporting entities apply the guidance in IAS 39, *Financial Instruments: Recognition and Measurement*, which permits reporting entities to take into account the effects of offsetting positions in the same market risk (or risks) when measuring the fair value of financial instruments.

BC25. The Boards understand that although those approaches are articulated differently in U.S. GAAP and IFRSs, they result in similar fair value measurement conclusions in many cases. However, the Board is aware that the guidance currently in Topic 820 could be interpreted more broadly than the Board intended, such as when a reporting entity uses the in-use valuation premise to measure the fair value of a group of financial assets when the reporting entity does not have offsetting positions (that is, financial liabilities) in a particular market risk (or risks) or counterparty credit risk.

BC26. The Board believes that the accounting for financial instruments should provide information about the risks inherent in financial instruments on the basis of how a reporting entity manages its business so that users of financial statements can assess the amounts, timing, and uncertainty of future cash flows. That is reflected in the Board's decisions in its project on the accounting for financial instruments, which reflects a *business strategy* approach for the accounting for financial instruments.

BC27. However, the guidance for measuring the fair value of financial instruments, including those that are managed on the basis of a reporting entity's net risk exposure, does not clearly articulate the relationship between a reporting entity's business strategy and the fair value measurement of financial instruments that are managed in that way. For example, Topic 820 does not explicitly address how the following meet the objective of a fair value measurement for financial instruments:

a. Reporting entities typically do not manage their exposure to market risks and credit risk by selling a financial asset or transferring a financial liability (for example, by unwinding a transaction). Rather, they manage their risk exposure by entering into a transaction for another financial instrument (or instruments) that would result in an offsetting position in the same risk.
b. The resulting measurement represents the fair value of the net risk exposure, not of an individual financial instrument. The sum of the fair values of the individual instruments is not equal to the fair value of the net risk exposure.
c. A reporting entity's net risk exposure is a function of the other financial instruments held by the reporting entity and of the reporting entity's risk preferences (both of which are entity-specific decisions and, thus, do not form part of a fair value measurement). Market participants might hold different groups of financial instruments or might have different risk preferences, and it is those factors that are taken into account when measuring fair value. However, the Board understands that market participants holding that particular group of financial instruments and with those particular risk preferences would be likely to price those financial instruments in the same way (that is, using the same valuation techniques and the same market data). As a result, the measurement of those financial instruments within that particular group is a market-based measurement.

BC28. As a result, the Board decided to permit an exception to the requirements in Topic 820 for measuring fair value when a reporting entity manages its financial assets and financial liabilities on the basis of the reporting entity's net exposure to market risks or counterparty credit risk. That exception permits a reporting entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk exposure or to transfer a net short position (that is, a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date. That exception also applies to derivatives that the reporting entity is required to or has elected to measure at fair value in accordance with the guidance in Topic 815, Derivatives and Hedging, or in Topic 825, Financial Instruments.

BC29. The Board decided to specify that to be able to use that exception, a reporting entity must provide evidence that it manages its financial instruments on the basis of the reporting entity's net exposure to those risks on a consistent basis. Evidence that the reporting entity is managing its financial instruments in that way includes having a documented risk management or investment strategy describing the management of financial instruments within the organization and providing information about the net risk exposure to management. Furthermore, the Board decided to specify that the reporting entity must be required (or must have elected, for example, under the fair value option) to measure the financial instruments at fair value on a recurring basis.

BC30. In addition, the Board decided to specify that the market risks that are being offset must be substantially the same for a reporting entity to be able to use that exception. The Board concluded that a reporting entity should be permitted to apply the bid-ask spread guidance in this Topic to the reporting entity’s net position in a particular market risk (rather than to each individual financial instrument comprising that position) when the market risks that are being offset are substantially the same. For example, a reporting entity may apply that exception when it uses that group of financial instruments to identify and manage its exposure to a particular type of interest rate risk alone, not when the reporting entity uses that group of financial instruments to manage all market risks to which the entity is exposed.

BC31. The Board also decided to specify that the reporting entity may consider its net exposure to counterparty credit risk only when there is a legally enforceable right of offset (for example, a master netting agreement) with the counterparty in the event of default. Without a legally enforceable right of offset, the Board believes that market participants would take into account the gross exposure, rather than the net exposure, to the credit risk of a particular counterparty when measuring fair value.

BC32. The Board noted that the group of financial assets and financial liabilities for which a reporting entity manages its net exposure to a particular market risk (or risks) might differ from the group of financial assets and financial liabilities for which a reporting entity manages its net exposure to the credit risk of a particular counterparty.