STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**Summary of feedback received from outreach activities**
Paper topic	IFRS 13 *Fair Value Measurement* –The fair value hierarchy when third-party consensus prices are used

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Purpose of the paper

1. The purpose of this paper is to provide a feedback summary from the additional outreach performed by the staff following a request made by the IFRS Interpretations Committee (the 'Interpretations Committee'). The Interpretations Committee will not be asked to make any decisions as a result of this feedback and therefore this paper does not present the staff's view.

Background

2. In September 2014, the Interpretations Committee published a tentative agenda decision not to add to its agenda a request to clarify the circumstances in which prices provided by third parties (especially consensus prices) qualify as a Level 1 input in the fair value hierarchy in IFRS 13 *Fair Value Measurement*.

3. More specifically, the Interpretations Committee was asked to consider what the correct fair value hierarchy level is for debt securities such as government bonds that are traded in active markets but that are priced using third-party consensus prices.

4. The Interpretations Committee considered the results of the outreach request performed by the staff. The outreach indicated that there was no significant diversity observed in practice on this issue.

5. The Interpretations Committee observed that this issue is not widespread and that the guidance in IFRS 13 is sufficient to draw an appropriate conclusion on the issue submitted. The Interpretations Committee therefore determined that neither an Interpretation nor an amendment to the Standard was necessary.

6. Consequently, the Interpretations Committee decided to issue a tentative agenda decision that can be found in the *IFRIC Update* of September 2014.

7. In January 2015, the staff presented an analysis of comment letters received relating to the tentative agenda decision. As part of this analysis, it was noted that two respondents supported the tentative agenda decision, one respondent did not and another respondent had raised follow-up questions, which, in their view, required further consideration (see paragraph 12).

8. In considering the comments received, the Interpretations Committee noted that a fair value measurement that is based on prices provided by third parties may only be categorised within Level 1 of the fair value hierarchy if the measurement relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date.

9. Consequently, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and decided not to add this issue to its agenda.

10. However, in finalising the agenda decision, the Interpretations Committee noted that it would be helpful to further understand the additional questions raised by respondents during the comment period and requested that additional outreach be undertaken for informational purposes. In this regard, the Interpretations Committee would *not* be asked to make any decisions when such feedback is presented.

11. The full text of the final agenda decision is reproduced in Appendix A.

Questions asked as part of outreach undertaken

12. We asked national standard-setters and their advisors, large accounting firms and securities regulators the following questions:

    (a) What is the classification within the fair value hierarchy of a financial instrument when the fair value measurement is based on a model or valuation technique that only uses unadjusted quoted prices or Level 1 inputs **(Q1)**?; and

    (b) Can certain types of quotes or executable prices (for example, third party quotes that represent binding offers) as opposed to actual transaction prices be considered to meet the definition of Level 1 inputs **(Q2)?**

13. The staff also sought the informal views of pricing service providers in respect of **Q1** and **Q2**. A summary of the feedback received is outlined in paragraph 34 and 35 of this paper. In addition, the staff received informal feedback from a financial institution which is summarised in paragraph 36.

Responses from national standard-setters and their advisors, accounting firms and regulators

14. We received responses from:

    (a) 8 national standard-setters and their advisors;

    (b) 4 large accounting firms; and

    (c) 2 securities regulators.

15. We summarise the results of the outreach in the following paragraphs. The views expressed below are informal opinions from national standard-setters, accounting firms and securities regulators. They do not reflect the formal views of those organisations.

Responses received from national standard-setters and their advisors

16. With respect to **Q1,** a number of respondents stated that a fair value measurement based on a model or valuation technique that only uses unadjusted quoted prices or Level 1 inputs would not be categorised within Level 1 of the fair value hierarchy.

17. To support this view, respondents raised the following points:

    (a) The use of a model or valuation technique in pricing a financial instrument indicates that there is no active market for that particular instrument and would therefore preclude classification within Level 1 of the fair value hierarchy in accordance with paragraph 74 of IFRS 13;

    (b) Applying a model or valuation technique results in the price of a financial instrument being adjusted in accordance with the assumptions and conditions inherent in the model or valuation technique;

    (c) Financial instruments priced using a model or valuation technique and Level 1 inputs should be categorised within Level 2 of the fair value hierarchy in accordance with paragraph 82 of IFRS 13 which notes that Level 2 inputs include 'inputs *other* than quotes prices that are observable for the asset or liability';

    (d) Models and valuation techniques may be proprietary or based on algorithms that are not observable hence precluding Level 1 classification; and

    (e) Prices determined using a model or valuation technique, including consensus prices provided by third parties, are not 'pure market prices' in that they are aggregated prices from markets that are not necessarily active.

18. Some respondents stated that it may be possible that a fair value measurement based on a valuation technique and using only Level 1 Inputs could be categorised within Level 1 of the fair value hierarchy but they did not provide detailed reasons.

19. Some other respondents expressed the view that Level 1 classification was theoretically possible although this was not expected to be common practice. More specifically, they noted that consideration should be given as to whether the valuation technique or model used in pricing an instrument was commonly applied and representative of industry practice.

20. Another respondent noted that classification within Level 1 of the fair value hierarchy involved an assessment of whether an active market exists and whether the prices were adjusted or not.

21. With respect to **Q2**, most respondents were of the view that it was *possible* for quotes or executable prices to meet the definition of Level 1 inputs but this was subject to an assessment of the relevant facts and circumstances relating to the nature of the quotes or prices provided. In particular, respondents were of the view that quotes or executable prices *could* meet the definition of Level 1 inputs in the following instances:

    (a) The quote is a binding offer that can be accessed at the measurement date and there have been recent actual transactions in an active and sufficiently deep market that corroborate the reasonableness and validity of the binding offer;

    (b) A quote derived from a model or valuation technique is based on direct Level 1 inputs;

    (c) An active market exists *and* the price is an executable quote in that active market as evidenced by the exchange of financial instruments rather than binding offers only; and

    (d) The valuation was based on executable observations of identical securities that formed a tight pricing model (indicated by a small standard deviation) and is consistent with the entity's understanding of an acceptable bid-ask spread of a particular instrument.

22. Some other respondents were of the view that a binding offer or executable prices would not meet the definition of Level 1 inputs on the basis that they were not actual transaction prices.

Responses received from large accounting firms

23. With respect to **Q1**, while one respondent acknowledged that Level 1 classification may be possible where the valuation technique was a simple average most respondents were of the view that a fair value measurement based on a model or valuation technique that only uses unadjusted quoted prices or Level 1 inputs would not be categorised within Level 1 of the fair value hierarchy.

24. To support their view that a Level 1 classification would not be appropriate, respondents noted the following points:

    a) The model or valuation technique may involve proprietary or complex algorithms (or other non-transparent adjustments) which would be inconsistent with concluding that the resulting values represent unadjusted quoted prices;

    b) The model or valuation technique may use quoted prices obtained at different points in time over a period leading up to the measurement date, with the different prices being adjusted to reflect their different timing;

    c) The use of a model or valuation technique infers that there is some form of calculation or adjustment being applied; and

    d) The existence of a quoted price in an active market as of the measurement date for the particular item measured is incongruent with the need to use a model for valuation.

25. With respect to **Q2**, some respondents were of the view that certain types of quotes or executable prices *could* meet the definition of Level 1 inputs in certain circumstances. In particular, the following points were raised:

    (a) Current quoted bid and ask prices from market makers or exchanges may be more representative of the price at which a market participant could sell an asset at the measurement date rather than the prices of actual transactions that occurred at an earlier point in time;

    (b) Determining whether a binding offer or executable price would meet the definition of Level 1 inputs depends on specific facts and circumstances. For example, it would be unusual for binding offers to be available at widely different price levels if the market is active whilst a wide bid-ask spread may be associated with a market not being active; and

(c) The quote or price would need to be in an active market for the identical asset or liability being measured at the measurement date. For example, a binding quote for a single piece of real estate would not represent a Level 1 price as there is no active market (as defined in Appendix A of IFRS 13) for that unique piece of property.

26. Some other respondents were of the view that quotes or executable prices had to be derived from actual market activity.

Responses received from securities regulators

27. We received responses from securities regulators who have included the views of their respective members.

28. As regards **Q1**, the staff noted some mixed views.

29. Based on the feedback received, one securities regulator indicated that a fair value measurement based on a model or valuation technique that only uses unadjusted quoted prices or Level 1 inputs would not be categorised within Level 1 of the fair value hierarchy.

30. The other securities regulator indicated that their members had not observed this issue in practice. However, when asked to comment on what they considered to be the correct approach, the majority of those members concluded that Level 1 would be appropriate with only a significant minority concluding that Level 1 would not be the appropriate classification.

31. Those supporting Level 1 classification did not provide detailed reasoning. However, in support of the view against Level 1 classification, securities regulators provided the following comments from their members:

(a) Using Level 1 inputs in a valuation technique would lead to quoted prices that are adjusted and as a result they would not meet the definition of a Level 1 input in accordance with paragraph 76 of IFRS 13;

(b) Fair value measurements determined using a valuation technique or model creates doubt as to whether an entity can enter into a transaction for an asset or liability *at the price in market* at the measurement date as outlined in paragraph 78(b) of IFRS 13 in respect of Level 1 inputs;

(c) The model or valuation technique *itself* is not a Level 1input and hence the valuation would entail the use of a significant input which is not a Level 1 input; and

(d) Classification within Level 1 of the fair value hierarchy was generally limited to instruments whose fair value could be determined directly by referencing public quotations on organized exchanges and which are available in active markets.

32. With regard to **Q2**, most of the feedback received from securities regulators indicated that their members were of the view that only quoted prices in active markets would be Level 1 inputs hence prices determined by sources other than actual transactions would not qualify.

Other comments received from national standard-setters and their advisors, accounting firms and securities regulators

33. Other comments received included the following:

(a) There may be a perception in practice and across industries that the classification within the different levels of the fair value hierarchy was a measure of asset quality and as such an indication of the relative risk of the financial instrument. Consequently, financial instruments classified within Level 2 and Level 3 are perceived to be 'riskier';

(b) Third party pricing providers have only recently started to evolve towards more transparency around their pricing methodologies although the level of transparency is quite diverse. In many cases, the specific calculations and models used for pricing securities are retained as proprietary information; and

(c) In respect of prices provided by third parties including consensus prices, pricing policies and procedures should be put in place which considers the different levels of the fair value hierarchy and how active the market is behind the prices that have been used to measure the fair value of a particular financial instrument.

Other feedback received

34. Pricing service providers outlined a high level overview of their pricing methodologies without delving into specific details around proprietary algorithms or models used for pricing securities. They also touched on how they might determine whether a quote is executable or binding in nature citing considerations around whether there is an active market, the inventory of the broker and evidence of recent transactions.

35. They also made a number of other observations, including the following:

(a) Some of the fair value models and tools which they are developing are being used by clients in order to assist them in determining the appropriate level of classification within the fair value hierarchy. In this regard, they noted the transparency of the models used and the ability to customise any tools was a key consideration for clients;

(b) A large part of their services focused on assisting clients with the distinction between Level 2 and Level 3 when classifying financial instruments within the fair value hierarchy; and

(c) Transaction prices are not always the most representative or most accurate reflection of fair value and as such adjustments are often required.

36. In respect of feedback received from a financial institution, the respondent commented on both questions raised. As regards **Q1**, the respondent observed that an input fed into a model or valuation technique is unlikely to result in a price that is unadjusted unless it is identical to the input. Consequently, a valuation derived using a valuation technique which uses only Level 1 inputs would not be classified as Level 1 within the fair value hierarchy. However, as regards, **Q2**, the

respondent also commented that, providing they are binding executable quotes available with sufficient frequency, Level 1 classification may be appropriate.

Discussion Point

37. Do the members of the Interpretations Committee have any comments regarding the outreach feedback provided in this paper?

Appendix A—Final agenda decision

IFRS 13 Fair Value Measurement—the fair value hierarchy when third-party consensus prices are used

The Interpretations Committee received a request to clarify under what circumstances prices that are provided by third parties would qualify as Level 1 in the fair value hierarchy in accordance with IFRS 13 *Fair Value Measurement*. The submitter noted that there are divergent views on the level within the hierarchy in which fair value measurements based on prices received from third parties should be classified.

The Interpretations Committee noted that when assets or liabilities are measured on the basis of prices provided by third parties, the classification of those measurements within the fair value hierarchy will depend on the evaluation of the inputs used by the third party to derive those prices, instead of on the pricing methodology used. In other words, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. In accordance with IFRS 13, only unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date qualify as Level 1 inputs. Consequently, the Interpretations Committee noted that a fair value measurement that is based on prices provided by third parties may only be categorised within Level 1 of the fair value hierarchy if the measurement relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date.

The Interpretations Committee also observed that the guidance in IFRS 13 relating to the classification of measurements within the fair value hierarchy is sufficient to draw an appropriate conclusion on the issue submitted.

On the basis of the analysis performed, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee decided not to add this issue to its agenda.