

The road ahead*

Challenges for investment management in a world of change
Fair value disclosures

May 2009



In March 2009, the International Accounting Standards Board (“the IASB” or “the Board”) issued amendments to IFRS 7, *Financial Instruments – Disclosures* (“IFRS 7”) intended to improve disclosures about fair value and liquidity risk. The Canadian Accounting Standards Board (“the AcSB”) followed suit, announcing in its March 25-26 Decision summary that it will adopt the amendments into Canadian generally accepted accounting principles (“GAAP”) Section 3862, *Financial Instruments – Disclosures*.

“The more you explain it, the more I don’t understand it.”

Mark Twain

Those familiar with U.S. GAAP are sure to recognize the new guidance as it’s derived largely from Statement of Financial Accounting Standards 157, *Fair Value Measurements* (“SFAS 157”). Its introduction into IFRS was partly motivated by a desire to increase comparability between IFRS and U.S. GAAP. The good news is that if you applied SFAS 157 to some of your products over the past year, extrapolating the process to include your funds that report under Canadian GAAP or IFRS should be relatively straight-forward. On the other hand, if you’ve never heard of SFAS 157, there is likely some work ahead.

Under IFRS, the amendments apply to annual periods beginning on or after January 1, 2009, with early adoption permitted. Although the final Canadian version hasn’t yet been issued, the AcSB has suggested it will apply to annual financial statements for fiscal years ending after September 30, 2009, with early adoption permitted. For funds with a calendar year-end the new disclosures will be required in their 2009 (that’s right, 2009) annual financial statements. Fortunately, comparatives will not be required in the year of adoption.

What’s changed?

The amendments introduce a “fair value hierarchy” for disclosures which intends to provide information to financial statement users about the relative reliability of fair value measurements. Determining the appropriate levels in which to classify instruments is likely to be a daunting task, particularly during times of significant market volatility and with less than a year to implement.

For each class of financial instruments, entities will need to disclose the methods used to determine fair values, including whether a valuation technique was applied. If a valuation technique has been applied, the assumptions made and the reasons for any changes are also required. In disclosing the fair value hierarchy, classification is required for only those instruments that are measured at fair value on the balance sheet which would generally include all investments of an investment fund.

The definition of liquidity risk and related disclosures have also been amended to clarify that liquidity risk refers only to those financial liabilities that are settled in cash or another financial asset.

This issue of *The road ahead** looks only at the new fair value hierarchy disclosure requirements.

New fair value hierarchy disclosures

The more notable items that will require disclosure on adoption of the amendments include:

- Classification of fair value measurements using a fair value hierarchy:

- Level 1 – quoted prices in active markets for identical assets or liabilities,
- Level 2 – valuation methods that make use of directly or indirectly observable inputs, and
- Level 3 – valuation methods that make use of unobservable market data as inputs, including models.

Observation: Generally, this information will be disclosed by including a table that illustrates the classification of fair values for each class of financial instruments that are carried at fair value. For an example of how this might appear, refer to the PricewaterhouseCoopers publication, *The new financial instruments disclosures: Recent amendments to CICA 3862, Financial Instruments - Disclosures*.

- Significant transfers between Levels 1 and 2, including the reasons for those transfers.

Observation: Significance is determined by reference to profit or loss, total assets or total liabilities. Considerable judgment may be needed in determining which transfers will require disclosures.

- Reconciliation of the opening balance to the ending balance for instruments, disclosing changes attributable to:

- Total gains or losses included in net income,
- Total gains or losses included in other comprehensive income,
- Purchases, sales, issues and settlements, and
- Transfers into or out of level 3 and the reasons for those transfers.

Observation: Investment funds are typically required to account for gains and losses in net income and thus will not have any amounts in Other Comprehensive Income. In most cases, these disclosures will consist of a table that shows (by class of financial instruments carried at fair value) the opening balance in Level 3, plus or minus: net purchases or net sales of such instruments, transfers of instruments into or out of Level 3 (e.g., due to changes in the observability of fair value inputs) and realized and unrealized gains and losses, totalling to the ending balance in Level 3.

- Gains and losses included in net income (or comprehensive income, if applicable) that are related to instruments whose fair values are classified as Level 3 including:

- The amount of gains or losses included in net income for the period related to assets or liabilities that are held at the end of the reporting period, and
- A description of where those gains or losses are included in the income statement.

Observation: This requirement will often be satisfied by showing separately realized and unrealized gains (losses) on Level 3 securities in the Level 3 reconciliation, noted above.

Although comparatives aren't required in the year of adoption, the classification of financial instruments that are measured at fair value in the opening balance sheet will be needed to calculate the roll-forward for Level 3, as well as the disclosures of transfers for Levels 1 and 2.

Quoted prices and inputs

Level 1 classification will be obvious for some quotes – e.g., bid quotes for an exchange-traded security with significant volume. On the other hand, it might be less straight-forward for others – e.g., certain corporate bonds and other fixed income securities, securities traded over-the-counter (“OTC”), private securities including private investment in public equity (“PIPES”), and OTC derivatives.

Some fixed income securities are exchange-traded, though many are not and thus broker quotes are often relied on for valuation. The use of broker quotes received a lot of attention over the past year (particularly from regulators) and there seems to be little consistency in practice as to how they’re classified within the hierarchy. For example, many wonder whether or not a broker quote represents a “quoted price in an active market” and how the answer might change depending on factors such as whether or not the quote is indicative versus executable, or whether the security trades often or thinly.

In practice, similar logic has often been applied to determine the treatment of securities that are traded on OTC markets – e.g., the NASDAQ. Frequency and volume of trades are crucial considerations and may lead to classification as level 1, 2, or 3. As well, not all private securities will necessarily be level 3 – e.g., recent transactions in the same or similar securities, or available quotes for the registered versions of equities associated with PIPES, may lead to level 2 classification.

Derivatives will also likely lead to confusion. Some derivatives (e.g., certain futures and options) are exchange-traded, while others are not. Classification of exchange-traded contracts or contracts such as foreign exchange forwards (i.e., where the forward rate is readily observable) might be less challenging, though determining how to classify values that are derived using market data, but for which some adjustment is required, requires significant judgment. For example, some may conclude that interpolation between two forward prices to calculate the forward rate (e.g., for a maturity that’s not directly observable) is level 2 – others might not. Moreover, if extrapolation, as opposed to interpolation, is needed (e.g., if the maturity is beyond the farthest observable point on the curve), the conclusion is likely to be significantly different.

The distinction between levels 2 and 3 can be subtle in many cases and may lead to contentious outcomes.

Classification policies and guidelines

One of the first challenges in adopting the amendments will be developing internal policies and guidelines for fair value classification.

A good start might be to define the population at a high level and determine the primary source of values for each group of instruments. The result may be a list of all different valuation sources, which can then be used to determine where each would appropriately fit within the hierarchy. Processes can then be developed to identify events that trigger movements between each level.

Communication

Implementing the amendments is going to require substantial coordination as the pricing function naturally involves several groups – e.g., fund accountants, brokers, pricing vendors, other third-party service providers and often, portfolio managers. Classifying values obtained from pricing vendors can be tricky and information will often be needed about how their values are determined and where their information comes from. Since the adoption of SFAS 157, some service providers have developed their own “recommended” classifications. As always, management has ultimate responsibility for fair values and their classification, so management will have to ensure that classifications are consistent with their internal policies, even when recommendations are available.

Reconciliation of level 3

Identifying and tracking movements into, out of and within the Level 3 category can be difficult and is likely to require changes to systems to allow for identification or “tagging” of securities or transactions affecting Level 3. Among others, processes might be needed to identify when:

- An event triggers the reclassification of a previously held security into, or out of, the Level 3 category;
- A Level 3 security is purchased or sold; and
- Gains or losses on Level 3 securities are recorded in net income.

For portfolios that hold a limited number of securities, or that hold large-cap equities only, tracking this information may not be a big task. On the other hand, funds investing in derivatives, certain debt securities or other instruments with values that are frequently unobservable, will need well-coordinated processes.

For more information

If you would like to find out more about our investment management practice and how we can help, you can contact one of the following in the PricewaterhouseCoopers Investment Management Group.

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