

November 20, 2009

## The Fair Value Hierarchy Disclosures – Understanding and Applying Section 3862

In 2009 the Accounting Standards Board (“AcSB”) amended CICA Handbook Section 3862, *Financial Instruments – Disclosures* (“Section 3862”), to require enhanced disclosures about the relative reliability of the data, or “inputs”, that an entity uses to measure the fair values of its financial instruments. The new requirements are effective for annual financial statements for fiscal years ending after September 30, 2009. For an entity with a calendar year-end this means that the disclosures will be required in its December 31, 2009 annual financial statements.

Understanding and applying the requirements can be challenging. In this memorandum, we briefly:

- Explain the background to the amendments;
- Review and comment on the requirements;
- Give an illustrative example of their application;
- Outline steps for preparing the disclosures;
- Identify and discuss the key drivers to the disclosures;
- Consider the classification of more common types of instruments subject to the requirements, such as quoted equity investments, investments in bonds, interest rate and cross currency swaps, and forward exchange contracts; and
- Discuss the transition requirements.

### Background

The AcSB issued the amendments to Section 3862 in response to criticisms during the financial crisis that disclosures about fair value did not provide financial statement users with sufficient insight about the reliability of fair value measurements. For example, users were not previously able to distinguish measurements based primarily on observable prices from those based principally on assumptions that could not be verified by reference to external sources.

The new requirements mirror changes made to International Financial Reporting Standards in IFRS 7 in 2009 and are based on requirements for recurring fair value measurements under US GAAP in ASC 820-10 (FAS 157). Unlike FAS 157, there is no requirement in Section 3862 to provide information about the relative

reliability of fair value measurements of non-financial instruments (e.g. fixed assets or goodwill that have been written down to their fair value at the balance sheet date).

### The Requirements

The new requirements are in paragraphs 27A and B of Section 3862. The heart of these disclosures is a “fair value hierarchy” that classifies financial instruments measured at fair value at one of three levels according to the relative reliability of the inputs used to estimate the fair values. Any instrument within the scope of the Section that has been measured at fair value on the balance sheet must be included within the hierarchy, including all instruments classified as “held-for-trading” or “available-for-sale”.

## The Fair Value Hierarchy

Classification	Input
Level 1	Quoted prices (unadjusted) in active markets for identical assets or liabilities.
Level 2	Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
Level 3	Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value hierarchy level at which a fair value measurement is categorized is determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. We discuss this process later in the memorandum. Classifications are accumulated for each class of instruments and the totals for each class are presented.

### Other disclosures

Other disclosure requirements include:

- Significant transfers between Level 1 and Level 2 for the period and the reasons for those transfers, separately disclosing and discussing transfers into and out of each level. For this purpose, significance is judged with respect to net income and total assets or liabilities.
- For fair value measurements in Level 3, a reconciliation from the beginning balances to the ending balances, disclosing separately changes attributable to:
  - a) Total gains or losses for the period recognized in net income, and a description of where such amounts are presented in the income statement;
  - b) Total gains or losses recognized in other comprehensive income;
  - c) Purchases, sales, issues and settlements (each movement is disclosed separately); and

d) Separate disclosure of transfers into or out of Level 3 attributable to changes in the observability of market data and the reasons for those transfers. For significant transfers, transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.

- The amount of total gains or losses for the period recognized in respect of Level 3 instruments that have been included in net income that are attributable to instruments held at the end of the period, and a description of where those gains and losses are presented in the income statement.

The amendments also modify existing requirements about disclosure of reasonably possible alternative assumptions that would significantly change fair value estimates. This disclosure is now limited to instruments classified as Level 3. An entity now must disclose the existence of such alternative assumptions, their effect and how they were calculated. For the purpose of disclosure, significance will be judged with respect to net income, and total assets or total liabilities, or, when changes in fair value are recognized in other comprehensive income, with respect to total equity. The new requirements also emphasize the need for disclosure about changes in methods used to estimate fair value.

Fair value hierarchy information must be provided in tabular format, unless another format is more appropriate.

## Illustrative Example of the New Fair Value Disclosures

We provide an illustrative example of some of the more significant additional fair value disclosures now required under Section 3862. The example does not purport to provide all of the disclosures that might be required in specific situations.

During 2009, CICA Handbook Section 3862, Financial Instruments – Disclosures (“Section 3862”), was amended to require disclosures about the inputs to fair value measurements, including their classification within a hierarchy that prioritizes the inputs to fair value measurement. The three levels of the fair value hierarchy are:

- Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly; and
- Level 3 – Inputs that are not based on observable market data.

The following table illustrates the classification of the Company’s financial instruments within the fair value hierarchy as at December 31, 2009<sup>1</sup>:

Financial assets at fair value as at December 31, 2009				
	Level 1	Level 2	Level 3	Total
Equities	123,874,432	4,324,098	329,147	128,527,677
Bonds	-	87,432,348	6,750,852	94,183,200
Foreign currency forward contracts	-	24,319,457	4,538,472	28,857,929
Options	4,382,129	10,270,653	3,872,306	18,525,088
Interest rate swap asset	-	1,385,742	-	1,385,742
	128,256,561	127,732,298	15,490,777	271,479,636

Financial liabilities at fair value as at December 31, 2009				
	Level 1	Level 2	Level 3	Total
Interest rate swap liability	-	2,415,368	-	2,415,368
	-	2,415,368	-	2,415,368

Investments in equities with a fair value of \$28,237,532 were transferred from Level 2 to Level 1 during the year as a result of increased activity in the market for securities that were not being actively traded in the fourth quarter of the prior year. Similarly, exchange-traded equity call options held by the Company with a fair value of \$2,214,321 were transferred from Level 2 to Level 1 as a result of increased activity in the market for the options.

The following table reconciles the Company’s Level 3 fair value measurements from December 31, 2008 to December 31, 2009:

	Fair value measurements using Level 3 inputs			
	Equities	Bonds	Foreign currency forward contracts	Options
<b>Balance at December 31, 2008</b>	3,324,575	14,899,325	4,489,089	(1,061,757)
Gain (loss) included in net income	1,523,584	(3,258,437)	1,778,245	7,869,243
Gain (loss) included in other comprehensive income	2,109,352	-	853,291	-
Purchases	-	873,245	-	-
Sales	-	(4,325,112)	-	-
Settlements	-	-	(3,129,458)	-
Transfers in (out)	(6,628,364)	(1,438,169)	547,305	(2,935,180)
<b>Balance at December 31, 2009</b>	329,147	6,750,852	4,538,472	3,872,306

Gains and losses on Level 3 instruments of \$7,912,635 are presented in foreign exchange gain (loss) and investment income in the income statement. Of this amount, \$2,731,590 is attributable to instruments that were held at December 31, 2009. During 2009, equity investments with a carrying value of \$6,628,364 were transferred out of Level 3 into Level 1 as the issuer completed an initial public offering that resulted in the investments being actively traded at December 31, 2009.

<sup>1</sup> Comparative information has not been presented in the table because this information is not required in the year of adoption. For periods subsequent to the year of adoption, comparative information would be necessary.

## Basic Steps for Preparing the Fair Value Hierarchy Disclosures

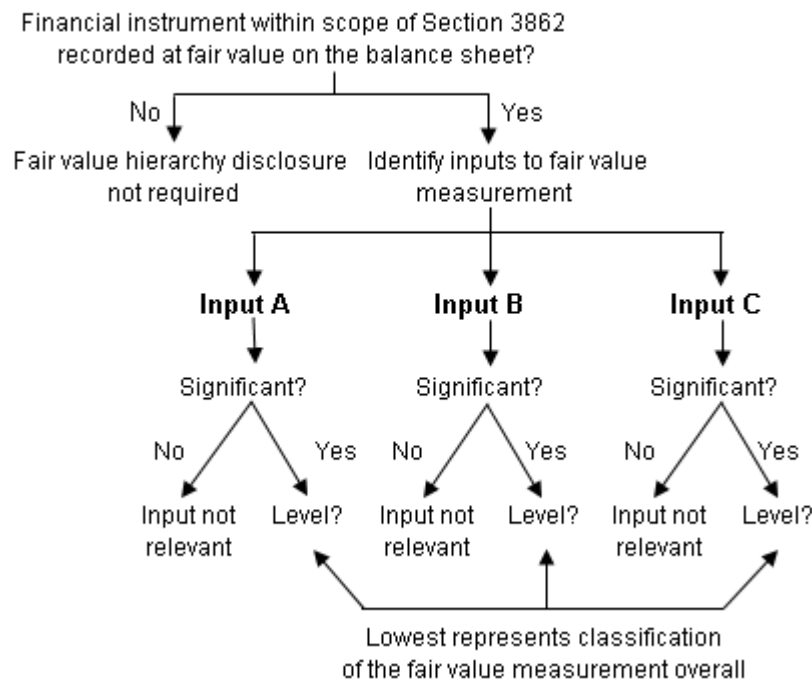
In order to prepare the fair value hierarchy disclosures, it is necessary to perform the following steps:

- Identify those financial instruments that fall within the scope of Section 3862 and that are measured at fair value on the balance sheet (the requirements apply to instruments accounted for on the cost basis that may have been written down to fair value at the balance sheet date – separate disclosure of such circumstances may be appropriate).
- For each instrument, identify the inputs used to measure its fair value at the balance sheet date.
- For each fair value measurement, determine which of those inputs are significant to the fair value measurement and classify each input as Level 1, 2 or 3.

- Classify an instrument as Level 1 only if the sole input to its fair value measurement is the price of the instrument quoted in an active market.
- Classify an instrument as Level 2 if it is not Level 1 and if all of the significant inputs to its fair value measurement are observable.
- Classify an instrument as Level 3 if at least one significant input to the fair value measurement is not observable.
- Group the instruments into appropriate classes (e.g. investments, derivatives, etc.) and include the aggregate fair value for each class and level in the fair value hierarchy table.

We illustrate the process for classifying individual instruments in the decision tree below.

### Fair Value Classification Decision Tree



## Key Drivers to Classifications

The following assessments are key drivers to classification of a financial instrument within the fair value hierarchy.

- Whether an input is observable or unobservable;
- If the input in valuing an instrument is its quoted price in a market, then whether the market is active. This will determine whether an instrument is classified as Level 1, or at a lower level; and
- If an instrument is not quoted in an active market, whether any input should be excluded from the classification assessment on the grounds that it is not significant in the measurement of fair value.

### Observable versus unobservable inputs

While Section 3862 distinguishes between “observable inputs” and “unobservable inputs”, it does not define these terms. FAS 157, on which the Section 3862 amendments were based, states that observable inputs “reflect the assumptions that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity”. By contrast, “unobservable inputs reflect assumptions that reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability developed based on the best information available in the circumstances”.

Examples of observable inputs include:

- Prices for instruments quoted in active markets (Level 1);
- Prices for similar instruments quoted in active markets (Level 2);
- Prices for identical or similar instruments quoted in markets that are not active (Level 2).

- Prices for instruments quoted in markets that are not active, including prices in transactions between private entities where the transactions and the prices are not made public (Level 2);
- Inputs other than quoted prices which are observable for the instrument (e.g. interest rates and yield curves observable at commonly quoted intervals, foreign exchange rates, volatilities, prepayment speeds, loss severities, credit risks and default rates (Level 2)); and
- Inputs that are derived principally from, or corroborated by, observable market data by correlation or other means (Level 2).

Level 3 inputs, by definition, are not observable. Such assumptions should be based on the best information available in the circumstances, which might include the reporting entity’s own data. In developing unobservable inputs, the entity need not undertake all possible efforts to obtain information about market participant assumptions, but cannot ignore any information that is reasonably available without undue cost or effort.

An entity often will ask banks or other service providers for an “indicative” price for a particular instrument and use that price as an input to fair value measurement. Absent other corroboration, these would be Level 3 inputs.

In some cases, the fair value of an instrument will be determined using a quoted price for similar assets, adjusted to recognize differences in terms or the liquidity of the instrument. The adjustment itself must be considered as an input to the valuation and classified within the fair value hierarchy. Often such adjustments are not observable.

### Active versus inactive markets

FAS 157 defines an active market as one in which transactions for an instrument occur with sufficient frequency and volume to provide pricing information on an ongoing basis. By contrast, a market that is not active

is one in which there are few transactions for the instrument, or price quotations vary substantially either over time or among market makers, or in which little information is released publicly (for example, a principal-to-principal transaction).

The focus of these definitions is on whether the market for the instrument is active, not whether the organization which provides the quoted price is active. For example, an equity instrument that is listed on the TSX should not be considered to be quoted in an active market merely because the daily volume of active trading on the TSX is significant. Securities listed on a venture exchange (e.g. TSX-V) or traded on over-the-counter markets (for example, on the NASDAQ or pink sheets) are more likely to be considered as being not quoted in an active market because quotes or transactions in these venues for individual instruments often are less frequent than on major exchanges.

### **Determining whether an input is significant**

Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the financial instrument. A starting point is to have a basic understanding of all of the inputs that factor into the fair value measurement, the relative significance of each of the inputs, and whether those inputs are externally verifiable or are derived through internal estimates. There are no bright lines for determining significance, and two different entities may determine that the same facts lead to different conclusions.

According to Section 3862, whether an input is significant must be assessed against the fair value measurement in its entirety. It would not be appropriate to conclude that an input is not significant because the fair value of the instrument relative the financial statements taken as a whole is not significant.

## **Classifying Common Types of Instruments**

The following discusses the classification of common types of financial instruments measured at fair value on the balance sheet.

**Quoted equity investments** – if an entity has estimated the fair value of an equity investment using the quoted market price for that instrument, its classification will depend on the entity’s determination of whether the market for the instrument was active at the measurement date. If yes, the instrument would be Level 1. If no, the instrument would be Level 2 or Level 3.

**Investments in bonds** – in general, bonds are traded over-the-counter and therefore it may be difficult to conclude whether a particular bond is traded in active market at the measurement date. Investors often obtain price quotes from brokers or other sources in estimating the fair values of bonds. If the entity obtains multiple quotes from different parties and the quotes are “executable” (i.e. the entity can transact at the quoted price with the counterparty), it may be appropriate to classify the instrument as Level 1. Otherwise, the instrument should be classified at a lower level. It usually would not be appropriate to consider quotes from pricing services that are based on quotes provided by multiple contributors as Level 1 because the pricing provided by the contributors usually is on an indicative basis only. Whether an investment in a bond whose fair value is determined based on quotes is classified as Level 2 or Level 3 depends on the particular facts and circumstances and judgment.

Fair values of bonds can be estimated by discounting future cash flows using yield curves and other assumptions as inputs (e.g. credit risk). If all significant inputs used to estimate the fair value are observable, then the instrument will be Level 2. If not, the instrument will be Level 3.

**Interest rate swaps, cross currency swaps and forward foreign exchange agreements** – if the fair value of these instruments is determined using a valuation model, the classification will depend on whether the periodic swap and other rates used in the model are observable over the full term of the instrument, or have to be extrapolated. If the rates for all periods are observable, the instrument would be Level 2. If not, the classification would depend on whether extrapolated amounts can be corroborated by other observable market data, or whether the extrapolation is insignificant to the fair value of the instrument. If neither of these conditions are met, the instrument would be Level 3.

## Transition

The fair value disclosure amendments to Section 3862 apply to annual financial statements relating to fiscal years ending after September 30, 2009, with earlier adoption permitted. If an entity adopts the new requirements early, it must state that fact. It is not necessary to provide comparative information in the year of adoption. Some required disclosures will involve determining the beginning of the year balances within each level of the hierarchy (e.g. significant transfers between Level 1 and Level 2 and the Level 3 reconciliation). Even though entities are exempted from providing comparative information in the year of adoption, they still must determine opening balances in order to provide these disclosures.

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