

Investment company technical release

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Fair value hierarchy disclosures - getting to grips with the new requirements

In order to improve the disclosure of how companies measure the fair value of their financial instruments, the disclosure requirements in IFRS 7 have been extended to introduce a fair value hierarchy, similar to that which is required under US GAAP. Subject to completion of the EU adoption process, the new disclosures are effective for annual periods beginning on or after 1 January 2009. Similar amendments to FRS 29 are in place for companies reporting under UK GAAP.

The hierarchy

The fair value hierarchy consists of the following three levels:

- Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset or liability
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The disclosures

For financial instruments within the scope of IFRS 7/FRS 29 that are measured at fair value, investment companies will need to disclose the following for each class of financial instruments:

- the level in the fair value hierarchy into which the fair value measurements are categorised
- any significant transfers between Level 1 and Level 2 and the reasons for those transfers
- for fair value measurements in Level 3, a reconciliation from the beginning balances to the ending balances. As well as highlighting purchases, sales, and gains and losses, this reconciliation will identify transfers into or out of Level 3 and the reasons for those transfers.

In addition, for any fair value measurements in Level 3 where changing one or more inputs to reasonably possible alternative assumptions would change fair value significantly,

entities are required to disclose that fact and the effect of those changes.

Because the disclosures relate to financial instruments that are measured at fair value, for the typical investment company these will comprise investments and derivative assets and liabilities in the most part. Debtors, creditors, cash, and borrowings will generally fall outside of the scope of the analysis.

Key considerations

One of the key points about the fair value hierarchy is that categorisation is based on the lowest level input that is significant to the fair value measurement of the instrument. The amendments make clear that when the fair value of an instrument is measured using some observable inputs, but these inputs require significant adjustment based on unobservable inputs, that fair value measurement should be categorised in Level 3.

For investment companies this will require careful consideration, and judgements will need to be made, particularly in terms of whether a particular input is significant. In practice, investments for which there is an exchange listed price will often fall into Level 1 and for some investment companies this may be the end of the deliberations. Unquoted private equity or venture capital holdings might however be generally expected to fall into Level 3. Depending on the circumstances, certain derivatives such as interest rate swaps or forward currency contracts where inputs are mostly observable might conceivably fall into Level 2. For some investment companies, it is possible that Level 2 might turn out to be the smallest of the three categories, but equally it may be the category that generates most discussion.

The quantitative disclosures are to be provided in a tabular format unless another format is more appropriate. For an investment company which has only Level 1 investments for example, it may be appropriate to explain this in a narrative format.

An illustration of how the tables might look for a hypothetical investment company with investments in all three categories of the hierarchy is set out below. The illustration assumes that available-for-sale assets are not held and that all assets measured at fair value are at fair value through profit or loss.

Fair value hierarchy disclosures – an illustrative example

The table below sets out fair value measurements using the IFRS 7 fair value hierarchy.

Financial assets at fair value through profit or loss				
At 31 December 2009				
	Total	Level 1	Level 2	Level 3
	£'000	£'000	£'000	£'000
Equity investments	75,850	63,250	-	12,600
Fixed interest investments	10,000	8,500	-	1,500
Derivatives	3,000	500	1,500	1,000
Money market funds	7,600	7,600	-	-
Total	96,450	79,850	1,500	15,100

Financial liabilities at fair value through profit or loss				
At 31 December 2009				
	Total	Level 1	Level 2	Level 3
	£'000	£'000	£'000	£'000
Derivatives	3,500	-	3,500	-
Total	3,500	-	3,500	-

Categorisation within the hierarchy has been determined on the basis of the lowest level input that is significant to the fair value measurement of the relevant asset as follows:

Level 1 - valued using quoted prices in active markets for identical assets

Level 2 - valued by reference to valuation techniques using observable inputs other than quoted prices included within Level 1

Level 3 - valued by reference to valuation techniques using inputs that are not based on observable market data

The valuation techniques used by the company are explained in the accounting policies note on page x.

There have been no transfers during the year between Levels 1 and 2. A reconciliation of fair value measurements in Level 3 is set out on the following page.

Level 3 financial assets at fair value through profit or loss
At 31 December 2009

	Equity investments	Fixed interest investments	Derivatives	Total
	£'000	£'000	£'000	£'000
Opening Balance	9,200	-	5,200	14,400
Purchases	6,700	1,400	800	8,900
Sales	(750)	-	-	(750)
Settlements	-	-	(4,700)	(4,700)
Transfers into Level 3	250	-	-	250
Transfers out of Level 3	(1,000)	-	-	(1,000)
Total gains or losses included in Gains on investments in the statement of comprehensive income:				
- on assets sold	(200)	-	(500)	(700)
- on assets held at the end of the year	(1,600)	100	200	(1,300)
Closing balance	12,600	1,500	1,000	15,100

Transfers into Level 3 relate to investments for which listing has been suspended during the year. Transfers out of Level 3 relate to investments which have obtained a stock exchange listing during the year, having previously been unquoted.

[Please note -

1. In addition to the disclosures above, for fair value measurements in Level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change the fair value significantly, the entity shall state that fact and disclose the effect of those changes. There continues to be a general requirement to disclose the methods applied in determining fair values of each class of asset or liability and, where a valuation technique has been used, to disclose the assumptions used.

2. If there has been a change in valuation technique for any class of asset or liability, the company is required to disclose that change and the reasons for making it.

3. The above illustrations do not include comparative information. Comparatives are not required in the first year of application but will be needed thereafter.]

Materiality

There is limited guidance in the standards as to when transfers between categories, or indeed categories themselves, are sufficiently significant as to warrant disclosure. In general, accounting standards do not apply to items that are immaterial, by reference to whether or not information would influence the economic decisions of users of the financial statements. Consideration would need to be given to the investment strategy of the fund on an ongoing basis as well as the significance of categories relative to NAV in order to determine whether Level 2 and Level 3 investments might be immaterial.

Current market conditions

The new disclosures have the primary aim of improving transparency in what have been challenging market conditions. Investors will be able to compare investment companies more than they have in the past in terms of the types of fair value measurements being made. Having said that, true comparability will only be achieved if the boundaries between the different levels of the hierarchy are interpreted consistently across the industry. As with most new accounting standards it may be that this will take time to settle down.

Care will need to be taken in current market conditions. If for example it is determined that a market for a particular security is inactive and significant adjustments need to be made to transactions or quoted prices to measure fair value, such adjustments may well be level 3 inputs in many cases. Even if no adjustments are considered necessary, the absence of an active market would preclude the investment from being categorised in Level 1.

The introduction of a fair value disclosure hierarchy does not affect the measurement requirements of IAS 39 or FRS 26. When implementing the new disclosures we would however recommend that companies take the opportunity to review their existing accounting policy disclosures relating to the use of valuation techniques. A full and clear description of the techniques used is important if the reader of the financial statements is to understand the basis of valuation and any critical assumptions which may have been made.

Effective date

Fair value hierarchy disclosures will be required in investment company financial statements for annual accounting periods beginning on or after 1 January 2009.

In the first year of application comparative information is not required. This exemption is however not quite as labour-saving as it first appears, as companies with Level 3 investments will need to establish which investments fall into this category at the beginning of the

period in order to be able to produce a Level 3 reconciliation. Similar considerations apply if companies are to be able to disclose any significant transfers between Level 1 and Level 2.

Conclusion

Investment company boards and their administrators should consider these new disclosure requirements ahead of the first applicable year end in order to ensure that they can be incorporated into the annual financial statements in a timely manner.

As highlighted above, one of the principal challenges which will be faced by some companies will be that of distinguishing Level 2 and Level 3 investments. Also, in order to be able to disclose transfers between categories and a Level 3 reconciliation it will be necessary to establish the opening position - this is an area where the relevant analysis could be performed ahead of the year end. Addressing this early would also enable any 'in principle' discussions with auditors regarding materiality to take place before the year end.

Contact us

If you would like to discuss any of the matters raised in this release further, please contact one of our investment company experts listed below.



Marcus Swales
T 020 7865 2320
E marcus.swales@gtuk.com



Alastair Robertson
T 020 7865 2275
E alastair.robertson@gtuk.com