Financial Accounting Standards Board

International Accounting Standards Board®

APPENDIX

BACKGROUND TO THE REQUEST FOR INFORMATION

This staff paper is intended to assist users in responding to the request for information about financial analysis related to fair values of financial instruments. However, this paper may not encompass all issues users consider important. The staff therefore encourages respondents to provide any further information they believe the Financial Accounting Standards Board and International Accounting Standards Board (the Boards) should consider.

THE MEANING OF FAIR VALUE

Fair value could be generally defined as the market clearing price at a point in time. If a current market clearing price is available an estimate of fair value is determined using that price. For an asset, the reported fair value is the current sales price, and for a liability, the reported fair value is the current price the debtor would have to pay to induce another party to assume the liability (that is, to layoff the obligation to another party).

Even if no market prices are available (because no transactions have occurred or information about them is not publicly available), the concept of fair value is still applied. An estimate of fair value is made using current market prices of similar instruments, or current market factors that would be considered by market participants, or both.

Fair value is sometimes loosely described as *mark to model* for instruments that are not actively traded and *mark to market* for those that are actively traded. Both are intended to represent fair value.

BREAKDOWN OF PAST CHANGES IN FAIR VALUE

Tentative Decisions Already Taken by the Boards

The Boards have tentatively decided that the total difference between beginning and ending fair values of each type of instrument and the related cash receipts and cash payments by each type of instrument should be reported. The Boards have not yet defined the word *types* in this context.

If types was defined by major type of financial instrument (for example, fixed income instruments, investments in equities, type of derivative etc.), then such information *could* be presented as follows:

Example—for investments in fixed income instruments:

	USD (m)	USD (m)
Opening fair values:		210
Cash (receipts)/payments:		
Purchases of new investments	30	
Sales of existing loans	(50)	
Other cash receipts	(10)	
Other changes in fair value:		
Change due to other factors*	**10**	
Closing fair values:		190

*Effectively the net amount reported in income.

Separately reporting interest and loan losses using the current calculation methods would not be consistent with measuring financial assets at fair value as they are based on the original transaction price and on company-specific estimates rather than current conditions and market factors. The Boards are therefore interested in what, if any, breakdown of the *change due to other factors* investors would find useful and how such breakdowns might be used in financial analysis.

The Boards have also tentatively decided that information should be disclosed about the relative measurement uncertainty of estimates in fair value (which also indicates the effect of measurement uncertainty on income of estimated changes in fair value) for different instruments (some disclosures are already required in this context).

Quantification of Changes in Fair Value by Cause

A quantification of the *effect of each cause* of change in the fair values of financial instruments is potentially useful information.

Changes in fair value may be caused by many things including changes in (1) market factors (such as risk-free interest rates or foreign currency exchange rates), (2) cash receipts and payments, (3) changes in credit quality, (4) the passage of time, and (5) estimation methods or valuation models.

Quantification of the effects on fair values of some of those factors may be very difficult or impossible to achieve in an objective way. For example, interest rates and other market factors affect the fair values of equity instruments, but quantifying those effects would normally be extremely difficult, if not impossible.

Quantifying the reasons for changes in the fair value of other types of financial instruments requires arbitrary assumptions which inevitably reduce the value of information to users of financial statements. For example:

1. The different factors that cause changes in fair values of financial instruments are interdependent. The fair value of a loan asset or an investment in a fixed-income bond is affected by the creditworthiness of the borrower, the risk-free (or benchmark) interest rate, sector spreads, liquidity considerations, and the passage of time. There is no objective method of separating the effects on fair value of changes in each of these individual factors.
2. The order in which the effects of changes in each of these individual factors are calculated affects the values that result. There is no objective way to determine the order.
3. The quantified effect of a single cause of changes in fair value also differs depending on the frequency of the calculations. Fair values change every day. If the effect of different factors on fair value is calculated daily, the results would be significantly different from the effects calculated retrospectively at the end of the reporting period.

Interest Income and Expense for Financial Instruments Measured at Fair Value

One possible way to analyze the change in the fair value of some financial instruments (such as loans or bonds) is to require separate reporting of interest income or expense. At present, interest income or expense consists of the accrual of any contractual interest plus the accretion of any discount (or amortization of any premium).

However, that method does not represent the current cost of funds or return on investments, which would seem to be more consistent with fair value measurement. On the other hand, it is not obvious how current cost or return might be reflected in financial statements because no universally accepted method exists to determine *fair value interest*. Any method used would inevitably involve arbitrary assumptions and be time consuming. It is also not clear that the result would be useful for analysis.

ANALYSIS OF EXPOSURE TO FUTURE CHANGES IN FAIR VALUE

Information that provides investors with information about future cash flows and exposures to future possible changes in the fair values of financial instruments held at a balance sheet date is arguably of greater use than any breakdown of past changes in fair value, given that the financial assets held and financial liabilities owed change from period to period.

Examples of forward-looking information include a list or quantification of factors (such as risk-free interest rates, credit spreads, or foreign currency exchange rates) that may cause future changes in fair values, a value-at-risk or similar analysis, or a list of future committed or contractual cash flows.

OTHER CONSIDERATIONS

Given that it is impracticable for issuers to include all types of possible information in their financial statements, please provide the Boards with your views on the relative importance of information about past changes in fair value and information about exposures to future changes.

In forming your views, the Boards would also like you to keep in mind how extensive the information might be that you are suggesting should be required.