THE NEW FAIR VALUE ACCOUNTING STANDARDS AND DISCLOSURE REQUIREMENTS

INTRODUCTION

Bloomberg launched BVAL, the Bloomberg Valuation Service, in the summer of 2008. The BVAL evaluated pricing service covers instruments across the full spectrum of the capital markets, with special emphasis on debt securities, loans and derivatives. In addition to the obvious goal of providing valuations that are of the highest quality and that are based to the greatest possible degree on market price input data, one of the most important objectives is to provide BVAL clients with significantly more transparency into valuation methodologies and pricing inputs than any other competing service. The transparency available through BVAL is intended to assist our clients in complying with their disclosure and reporting requirements much more easily.

This paper summarizes the current accounting requirements for reporting entities subject to reporting standards for each of IAS (International Accounting Standards) and US GAAP (Generally Accepted Accounting Principles) and identifies how BVAL is responsive to these requirements.

BVAL is based on Bloomberg’s unrivaled access to market data for global fixed-income securities and derivative instruments and our extensive data library in each segment of the global capital market. This information is combined with sophisticated analytics and models, each designed and maintained by capital markets specialists. BVAL produces high-quality valuations for both liquid and less liquid, harder-to-price instruments. Accounting requirements place the onus on reporting entities to understand and to disclose the pricing methodologies that drive the valuations used for their portfolios. Current disclosure requirements create the need for copious detail, which, in turn, requires meaningful transparency.

BVAL addresses clients’ needs for this transparency in the following ways:

• Additional fields of related metrics, besides the price, are provided in each output file

• BVAL Score, a measure of the quantity and quality of market data used as inputs to drive each valuation (to access a detailed primer on the BVAL Score from the Bloomberg Professional® service enter BVLI <GO> and choose “BVAL Documentation” or send an email to bval@bloomberg.net); Detailed documentation describing BVAL pricing methodologies (to access a detailed methodologies from the Bloomberg Professional service enter BVLI <GO> and choose “BVAL Methodologies” or send an email to bval@bloomberg.net)

• BVAL screen functionality with drill-downs into input and assumptive data, including a breakdown of the inputs used

• Transparent delineation of market data and unobservable inputs, including breakdowns of market-based pricing and model-driven pricing

• Access to BVAL’s team of evaluators—capital markets experts in the sector(s) they maintain

SUMMARY OF THE STANDARDS FOR FAIR VALUE MEASUREMENT AND REPORTING: ASC 820 AND IFRS 13

This section lists the major points addressed by ASC 820 and IFRS 13, together the “Standards.” Later in this paper, more detail is provided about each major point.

The Standards define fair value, establish a framework for measuring it and expand disclosures about fair value measurements. Fair value for
financial assets held by investors is defined by the Standards as, in effect, an exit price for an asset.\(^1\) It is the price that would be received to sell an asset in an orderly transaction that occurs in an active market between market participants at the measurement date, in what is defined as the “principal market.”\(^2\) An orderly transaction in an active market is a transaction featuring the usual and customary marketing activities\(^3\) that occur in a market in which transactions for the asset occur with sufficient frequency and volume to provide pricing information on an ongoing basis.\(^4\) The price should be based on information from the most advantageous market, usually the principal market, which is the market with the greatest volume and level of activity for the asset.\(^5\)

The framework established by ASC 820 and IFRS 13 not only defines fair value as an exit price but also explicitly requires a market-based price where available rather than an entity-specific price. This implies that the fair value principles are applied uniformly and universally, regardless of the nature of the owner. The size of a transaction that occurs in the market, however, may make an adjustment to the market price imperative if the transaction was either very large or very small and, therefore, not representative of the value in the market for a round lot transaction.

**SPECIFIC ACCOUNTING REQUIREMENTS**

The Standards specify that the use of actual market prices or the “relevant observable” market inputs should generally be maximized\(^6\) for valuations when available,\(^7\) except when markets are less liquid than usual.\(^8\) Should the prices and inputs available be the result of a forced liquidation or a distressed sale, then such market information is not representative of an exit price in an orderly market and may be disregarded.\(^9\) Observable market inputs are based directly or indirectly on executable market prices, modified mathematically to pertain to the target security (“... corroborated by observable market data by correlation or other means”).\(^10\) Unobservable inputs typically include non-executable broker indications and evaluations, as well as inputs based directly or mathematically from non-executable broker indications.\(^11\) The type of valuation method used for financial assets must be disclosed and must be labeled,\(^12\) according to the Standards, as belonging to either the Market Approach,\(^13\) the Income Approach,\(^14\) a mixture of the two methods or the Cost Approach.\(^15\)

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1 ASC 820-10-35-2
2 ASC 820-10-35-41 and ASC 820-10-35-41 B
3 ASC 820-10-35-41 B; see also ASU No. 2011-04 May 2011 “Fair Value Measurement (Topic 820),” p.199, definition of “Orderly Market”
4 ASC 820-10-35-41 B; see also ASU No. 2011-04 May 2011 “Fair Value Measurement (Topic 820),” p.194, definition of “Active Market”
5 ASC 820-10-35-41 B; see also ASU No. 2011-04 May 2011 “Fair Value Measurement (Topic 820),” p.199, definition of “Principal Market”
6 ASC 820-10-05-1 C
7 ASC 820-10-35-36 “Inputs to Valuation Techniques; General Principles”; see also ASC 820-10-35-53
8 ASC 820-10-35-54 C ....54 I
9 ASC 820-10-35-54 I “Identifying Transactions That Are Not Orderly”
10 ASU No. 2011-04 May 2011 “Fair Value Measurement (Topic 820),” p.198, definition of “Market-Corroborated Inputs”; see also ASC 820-10-55-3 C
11 ASC 820-10-35-54 K...M “Using Quoted Prices Provided by Third Parties”
12 ASC 820 10-35-24 A “Valuation Techniques”
13 ASC 820-10-55-3 A...C “Market Approach”
14 ASC 820-10-55-3 F...G “Income Approach”
15 ASC 820-10-55-3 D...E “Cost Approach”
The Standards require the disclosure of additional valuation detail, as follows:

- Fair Value at the end of the reporting period
- Assets divided into cohorts
- Asset cohorts sub-categorized by Fair Value Hierarchy
- Valuation technique used, changes to valuation techniques and the reasons
- Movements between different levels by asset cohort and the reasons (only public entities have to report movements between Levels 1 and 2)
- Level 2 observable input disclosure
- Level 3 unobservable input disclosure
- Level 3 narrative disclosure or tabular disclosure (under IFRS only) of other possible values of unobservable inputs (not required for non-public entities reporting under U.S. GAAP)
- Level 3 roll-forward analysis
- Liquidity disclosure*
- Interest rate risk disclosure*

It should be noted that the Levels 1, 2 and 3 mentioned in the list above are the levels defined in FAS 157, the U.S. predecessor to the fair value guidelines now embodied in ASC 820 and IFRS 13. The definitions of each of the levels under the Standards are given in the next section of this paper.

**FAIR VALUE DISCLOSURE DETAIL**

The three-level hierarchy originally specified in FAS 157 continues to frame the context of fair value disclosure.16

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**The Fair Value Hierarchy ranks the quality and dependability of the data used as inputs to generate a fair value price as follows:**

<table>
<thead>
<tr>
<th>LEVEL 1</th>
<th>LEVEL 2</th>
<th>LEVEL 3</th>
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<tr>
<td>Uses quoted market prices for the identical asset in active markets without adjustment.17</td>
<td>Uses observable market inputs (other than a Level 1 quoted price) or unobservable inputs that are corroborated by the market. Examples are: examining the market for similar assets and deriving interest rates, volatilities, yield curves, prepayment rates, loss severities or default rates based on that market information using mathematical or statistical techniques that include extrapolation, correlation or regression.</td>
<td>Uses a significant amount of unobservable inputs that cannot be corroborated by observable market data. The use of unobservable inputs is to be based on the best information available, including the reporting entity’s own data; however, market information that is available without undue cost and effort should not be ignored.</td>
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**CONSIDERATIONS FOR LEVEL DETERMINATIONS**

The guidance in the Standards requires that the use of relevant observable inputs be maximized and the use of unobservable inputs be minimized, with special emphasis on the word “relevant.” In some cases, prices based on transactions (in other words Level 1 inputs) do not represent the fair value for an asset in the market because of distressed sales, forced sales or announcements made after the transactions or after the close of business on the valuation date. Such market information will have to be adjusted in accordance with the reporting entities’ stated policies for adjusting market pricing.

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*The implementation date and the disclosure detail are still to be determined* 16 ASC 820 10-35-37
Inputs into fair value pricing that are on the surface unobservable from current market transactions but are based on mathematical or statistical techniques may be Level 2 inputs—if they can be corroborated with market data (i.e., if they are based on market data) that would normally be classified within Level 1 or Level 2 had they been used on an unadjusted basis.

The level in the hierarchy applicable to a fair value assessment based upon a combination of observable and unobservable inputs is determined by the lowest level of input that is significant to the fair value measurement in its entirety. In other words, even if the majority of the inputs are of Levels 1 or 2 quality, if a significant input into the fair value calculation is unobservable and cannot be corroborated by the market, then the nature of the lowest-level significant input determines the place in the hierarchy, i.e., Level 3.18 The determination of the relative significance of unobservable inputs is subjective and needs to be documented as a policy.

The classification level of evaluated pricing from third-party providers, such as Bloomberg’s BVAL service or competing service providers, could fall into any of the three levels in the hierarchy. The appropriate level is determined based on the source of the evaluated price. The reporting entity must know how the third-party provider determines the valuation and the relative amount of unobservable inputs involved either directly or indirectly in the calculation of the price. Consensus pricing based on surveying market participants who provide non-binding or mid-market valuations, even if there are numerous similar quotations, does not provide observable market information that would automatically lead to a Level 1 or 2 designation—absent corroboration by actual transactions or firm offers to buy or sell.

**CLASSES OF ASSETS**

ASC 820 and IFRS 13 state that a reporting entity should determine appropriate classes of assets and liabilities on the basis of the nature, characteristics and risks of the assets, noting that greater degrees of disaggregation might be required for fair value measurements categorized within Level 3 of the Fair Value Hierarchy. In the past, reporting entities disclosed fair value measurement information by “major categories.” Many reporting entities interpreted “major categories” to be the same categories that appear in the statement of financial condition.

Instead of specifically outlining the criteria of a class, ASC 820 provides guidance indicating that the nature and risk of the assets, as well as their classification in the Fair Value Hierarchy, should determine the number of classes. The classes should be done at least according to major security types—for example, as is done in a schedule of investments (SOI). Assets might be more appropriately disaggregated for disclosure purposes, however—separating security types in a more granular way by, for example, credit quality and/or the nature of the underlying business sector, geographic concentration, vintage, distance to first loss or other economic characteristics.

The reporting entity, in conjunction with its auditor, will determine the appropriate configuration for classes of assets that will be presented in order to disclose fair value measurement detail. If a particular line item in the SOI, for example, contains significant amounts in more than one Fair Value Hierarchy level, further disaggregation would be required. Incremental detail and a greater number of classes may be appropriate for investments classified as Level 3 because of increased uncertainty and subjectivity involved with the fair value measurements at that level and the consequent need for greater clarity and disclosure.
TYPE OF VALUATION METHOD
The type of valuation model, market approach or income approach used for every class of asset must be disclosed and the means of combining a market approach with an income approach must be disclosed as well. If the valuation method for a given cohort changes, then the change and the reason for the change must be disclosed.

The Market Approach includes actual observations of the target securities, the use of “market multiples” based on observations of similar securities, adjusted or unadjusted, and the use of pricing matrices that rely on relationships to a more liquid benchmark. The Income Approach includes discounted cash flow models and the use of option-pricing models.

When using multiple valuation techniques that produce a range of valuations, the reporting entity must maximize the use of relevant market data and minimize the use of unobservable inputs to determine the point within the range of valuations that best estimates the exit price in an orderly market based on current market conditions. Reporting entities are expected to have documentation to support how a mixture of market data and unobservable data was weighted to produce fair value prices and to report any changes in valuation methodology, i.e., when the majority of a valuation is produced by a revised mixture of the two types of inputs.

FAIR VALUE DISCLOSURE REQUIREMENTS

LEVEL 2 OBSERVABLE INPUT DISCLOSURE, LEVEL 3 UNOBSERVABLE INPUT DISCLOSURE AND DISCLOSURE OF VALUATION METHOD
For fair value measurements using observable inputs (Level 2) and significant unobservable inputs (Level 3), a reporting entity is required to disclose a description of the valuation technique(s) and inputs used in determining the fair values for each class of assets. Reporting entities must disclose changes in valuation techniques and the reasons for making such changes.

Examples of disclosures for inputs and valuation techniques include: a description of qualitative information about the inputs (e.g., default rates, discount rates and volatilities), the nature and detailed characteristics of the item being measured and the relative weightings applied to different types of valuation information, as well as a disclosure of how third-party information such as broker quotes, pricing services, cash flow valuations and other relevant market data are used to determine fair value. When multiple valuation methodologies are used within an investment class, disclosing the aggregate fair value by each valuation methodology utilized is recommended.

MOVEMENTS BETWEEN DIFFERENT LEVELS
The Standards require disclosure of any transfers into or out of Levels 1 and 2 and the reasons for such movements. Thus, a reporting entity must monitor all transfers, whether or not those transfers were deemed to be significant. Non-public entities do not have to report the movements between Level 1 and Level 2 of the Fair Value Hierarchy. 

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19 ASC 820 10-35-24 A “Valuation Techniques”
20 ASC 820-10-35-53
21 ASU No. 2011-04 May 2011 BC 106 a
SPECIFIC DISCLOSURE FOR LEVEL 3 ASSETS
For assets classified as Level 3, quantitative information about other possible values for significant unobservable inputs used in determining the valuations must be disclosed in a qualitative narrative, along with other possible valuations for the assets, unless a tabular presentation already exists or could be easily assembled to provide the disclosure.

As part of the effort to converge the U.S. and non-U.S. guidelines under ASC 820 and IFRS 13, the respective governing boards decided to require reporting entities to provide a narrative description by class of asset that captures the sensitivity of Level 3 assets to changes in the unobservable inputs used in the measurement if a change in those inputs to a different amount would result in a significantly higher or lower value. Further, any interrelationships between the unobservable inputs must be disclosed, and the extent to which an interrelationship would magnify or mitigate the effect of any change to an unobservable input needs to be explained. No specific tabular quantitative disclosure is required unless a table or other quantitative information exists or may be easily obtained, in which case the reporting entity must disclose that information. The boards will continue to assess whether requiring the disclosure of a quantitative measurement uncertainty analysis in tabular format would be practical. Non-public entities do not have to provide the disclosure of other reasonable values for Level 3 assets.22

LEVEL 3 ROLL FORWARD ANALYSIS
To provide clarity about the effect of Level 3 assets on financial results, the Standards contemplate a Level 3 roll forward table in the footnotes to the financial statements. A reporting entity must disclose a reconciliation of the beginning and ending balances for assets using significant unobservable inputs (Level 3 positions) by indicating the gains and losses for the period, purchases, sales, issuances, settlements and transfers in and/or out of Level 3 on a net basis. Under this requirement, the following changes to Level 3 assets are to be presented on a gross basis:

- Total gains or losses for the period recognized in profit or loss and the line item(s) in profit or loss in which those gains or losses are recognized—separately disclosing the amount included in profit or loss that is attributable to the change in unrealized gains or losses relating to those assets and liabilities held at the end of the reporting period and the line item(s) in profit or loss in which those unrealized gains or losses are recognized;

- Total gains or losses for the period recognized in other comprehensive income, including the line item(s) in which those gains or losses are recognized;

- Purchases, sales, issues and settlements (each disclosed separately); and

- The amount of any transfers into or out of Level 3 of the Fair Value Hierarchy, the reasons for those transfers and the entity’s policy for determining when transfers between levels are deemed to have occurred. Transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.

22 ASU No. 2011-04 May 2011 BC 106 b
USE OF THIRD-PARTY AND BROKER-DEALER PRICING SERVICES

The management of a reporting entity must understand the methods used by third-party pricing services and whether the prices used are market-based, model-based or a blend. Management also must understand what variable inputs into valuations are significant, how they might fluctuate over time or in different circumstances, and how other possible values to significant inputs are correlated to each other. Most important, management must understand when pricing service valuations are based on market transactions or binding bids and offers, as opposed to unobservable non-binding quotations. Further, it is recommended that the back testing of pricing-service valuations and broker-dealer quotations should be part of the ongoing monitoring procedures.

FAIR VALUE REPORTING FOR NON-MARK-TO-MARKET ASSETS

Topic 820 and IFRS 13 establish that the valuation practices they define will be the fair value standards used by reporting entities for disclosure of the fair value for assets not normally carried at fair value. Topic 825 (the so-called fair value option designed to codify previous guidelines under FAS 159 in the United States and IAS 39 under the international standards) requires a reporting entity to disclose the fair value of financial instruments even if they are NOT measured at fair value in the statement of financial position. An example is a financial instrument that is measured at amortized cost in the statement of financial position. Further, the Standards require a reporting entity to disclose the level of the fair value hierarchy in which a non-mark to market asset would have been categorized had it been measured at fair value in the statement of financial position. Once again, non-public entities are exempted from disclosing the level in the Fair Value Hierarchy and the valuation techniques used.

23 ASU No. 2011-04 May 2011 BC 103–105
24 ASU No. 2011-04 May 2011 BC 106 c