MALAYSIAN INSTITUTE OF ACCOUNTANTS

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FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE (“FRSIC”)

FRSIC Issue No. 46 [2014]
Determining the Significance of Unobservable Inputs

The issue:

MFRS 13 “Fair Value Measurement”, effective for annual reporting periods beginning on or after 1 January 2013, expands the disclosure requirements for the fair value hierarchy to include those financial instruments not measured at fair value but whose fair value is disclosed in the financial statements (paragraph 97).

The issue raised is determining the appropriate classification within the fair value hierarchy for instruments such as loans and advances to, as well as deposits from, customers. Key inputs to the fair value determination of loans and advances include the market interest rate as well as the counterparty credit risk. Whilst the market interest rate is observable, the credit risk adjustment is, in many cases, not observable, and the question becomes how ‘significant’ this input to the overall fair value determination.

MFRS 13.72 provides guidance for classification within the hierarchy: “the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Assessing the significance of a particular input to the entire measurement requires judgement, taking into account factors specific to the asset or liability”.

The following sets out a number of the factors that might be considered when determining the fair value of, for example, residential mortgage-backed securities:

1. Types of underlying loans (e.g. prime loans or sub-prime loans)
2. Collateral
3. Guarantees or other credit enhancements
4. Seniority level of the tranches of securities
5. The year of issue
6. The weighted average coupon rate and maturity of the underlying loans and securities
7. The geographical concentration of the underlying loans, and
8. Information about the credit ratings of the securities.

In classifying such an instrument in the fair value hierarchy, the significance of each unobservable input must be determined.

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Current accounting practice as observed by the Submitter:

MFRS 13 does not provide specific guidance on the determination of the 'significance' of an input, except that "assessing the significance of a particular input to the entire measurement requires judgement, taking into account factors specific to the asset of liability." Guidance from some of the accounting firms suggest that the use of sensitivity analysis or stress testing might be appropriate approaches to assess the effects of unobservable inputs on a fair value measure, alongside an analysis of the likelihood of variability in the input over the life of the asset or liability. In other cases, a qualitative assessment of the inputs may be sufficient.

The submitter had observed various practices in the market place, which can be summarised as follows:

1. Financial instruments with unobservable adjustments that are not considered 'significant' to the overall fair value measurement, or only in exceptional cases, are classified as Level 2.
2. Financial instruments in which the unobservable adjustments are viewed as significant in all respects, are classified as Level 3.
3. Financial instruments where the guidance in MFRS 7 is first applied in order to determine whether all fair values must indeed be disclosed. That is, paragraph 29 allows an exemption where the carrying amount of a financial instrument is a reasonable approximation of its fair value, disclosure of its fair value is not required. As a consequence, disclosure in the fair value is also not required.

Reasons for the FRSIC to address the issue:

There is significant divergence in practice in concluding whether unobservable adjustments to fair value measurements are considered 'significant' to the overall fair value measurement and therefore these adjustment would affect the classification of an instrument in the fair value hierarchy.

Submitter's proposal or recommendation to address the issue:

The submitter recommends the FRSIC considers issue a Consensus on the classification of fair value measures in the context of MFRS 13 fair value hierarchy, particularly with respect to the need to exercise judgement when determining the significance of unobservable inputs.

Submitted on:

4 April 2014

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Corresponding Guidance:

PROJECT WAS DISCONTINUED.

A survey was carried out to better understand the current practices of financial institutions (FIs) in Malaysia in relation to this issue. Following the findings of the survey, a review of financial statements of the FIs in Malaysia other than those that have responded to the survey as well as major banks in the UK, Australia and Hong Kong was undertaken. Both survey and review exercise observed mixed practices in the fair value measurement of loans and advances, as well as, deposits from customers by the FIs. The findings of the survey and review exercise were also shared with the FIs during an outreach session held in August 2016.

FRSIC has deliberated and has taken into consideration the findings from the survey and review exercise and responses from the FIs during the outreach session. FRSIC is of the view that the guidance in MFRS 13 is sufficient to determine the significance of a particular input to the fair value measurement of loans and advances and deposits from customers.

FRSIC decided that an article on the findings of the survey and review and also the feedback received during the outreach session would adequately address the concern raised by the submitter. The article is published on FRSIC website and can be accessed at http://www.mia.org.my/v1/frsic/ .

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