

# Classification of financial instruments within the IFRS 7 fair value hierarchy

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## 1. Introduction

The International Accounting Standards Board (IASB or the Board) finalised its amendments to IFRS 7 *Financial Instruments: Disclosures* in March 2009. These amendments reflect the IASB's response to the request by users of financial statements that IFRS 7 introduce a fair value hierarchy in its required disclosures, similar to that required in ASC 820, *Fair Value Measurements and Disclosures* (ASC 820) of the FASB Accounting Standards Codification. Overall, these amendments are intended to enhance disclosures about fair value measurement and liquidity risk - and are particularly relevant given the current economic turmoil.

The amendments require application for annual periods beginning on or after 1 January 2009; with early application permitted. The timing of this effective date is six months earlier than was originally proposed. However, in order to provide relief to entities in the first year of application, entities need not provide comparative information for the disclosures required by the amended paragraphs.

This publication offers some insights into how the amendments to IFRS 7, which require the classification of financial instruments recorded at fair value in a three level hierarchy, should be applied. The IASB introduced the requirement, as it concluded that this would improve comparability and help to further converge IFRS and US GAAP. The basis for conclusions in IFRS 7 clearly states that the fair value hierarchy disclosures required by IFRS 7 are the same as those in ASC 820. Consequently, we would not expect to find a difference between the application of IFRS 7 and ASC 820.

As the amended IFRS 7 disclosures are based on ASC 820, they are not necessarily the same as the hierarchical classification that some entities had previously given voluntarily. Entities will need to assess whether their existing disclosures comply with the new requirements. Significant areas of difference are likely to include over the counter (OTC) derivatives previously disclosed as level 1, and trades on which day one profit is deferred which may have all been reported as level 3. Both of these issues are discussed in more detail below.

The classification of financial instruments at fair value within a hierarchy requires judgment. To assist preparers with this, Appendix 1 contains examples of financial instruments indicating where in the fair value hierarchy the financial instrument is likely to be classified and the reasons for the classification. However, it is important to note that these examples are only intended to illustrate the considerations used in making such a determination. Preparers are responsible for determining the appropriate classification for instruments measured at fair value based on the facts and circumstances. These would include factors such as: a determination of whether the market for the instrument is active; and the observability of inputs used in the valuation technique.



## 2. IFRS 7 fair value hierarchy

IFRS 7 requires that the classification of financial instruments at fair value be determined by reference to the source of inputs used to derive the fair value. This classification uses the following three-level hierarchy:

- ▶ **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, 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).

## 3. Use of valuation techniques

The fair value hierarchy focuses on the inputs used in valuation techniques rather than the techniques themselves. While the availability of inputs might affect the valuation technique selected to measure fair value, IFRS 7 does not prioritise the use of one technique over another. The determination of the valuation technique to be used requires significant judgment and is dependent on the specific characteristics of the asset or liability being measured and the market in which market participants would transact to sell, transfer or settle the asset or liability.

## 4. Significance of inputs

The amended IFRS 7 makes repeated use of the word 'significant' in more than one context. Sometimes it refers to what is significant to the valuation of the instrument, on other occasions it refers to profit or loss, or total assets, or the entity's equity. Therefore, this term should be read with care.

Paragraph 27A of IFRS 7 states that the level within the fair value hierarchy, at which an instrument measured at fair value is categorised, is determined on the basis of the lowest level input that is significant to the measurement of fair value in its entirety.

Preparers should note that IFRS 7 requires an assessment not only of data entered into a pricing model to arrive at the 'mid market' value, but also any adjustments made to such values, in order to categorise the instrument measured at fair value. A risk adjustment to compensate for a risk inherent in a particular instrument or valuation technique (e.g., credit valuation adjustments (CVAs), costs of hedging/close out of risk, or a model adjustment) that market participants would demand, would be considered an input. Therefore, such an adjustment would need to be assessed and incorporated in the classification within the fair value hierarchy, if it is significant.

Often an asset or liability that is not traded with a quoted price in an active market will require more than one input to determine its fair value. For example, an OTC option on a traded equity security measured at fair value using an option pricing model requires the following market-based inputs:

- (i) Expected volatility
- (ii) Expected dividend yield
- (iii) The risk-free rate of interest

In this example, it is assumed that the risk-free interest rate and the dividend yield are level 2 inputs because they are directly observable, the expected volatility is determined to be a level 3 input (as might be the case with a long-dated option) and no risk adjustments have been applied. In this case, as volatility would typically be significant to the overall value of the option, the entire measurement of the instrument would probably be classified as level 3.

IFRS 7 does not provide specific guidance as to how an entity should determine the significance of individual inputs. This determination will require judgment and consideration of factors specific to the asset or liability (or group of assets and/or liabilities) being measured. In many cases, the use of sensitivity analysis or stress testing may be appropriate approaches to assess the effects of unobservable inputs on a fair value measure. In situations where more than one unobservable input is used in a fair value measure, the assessment of significance should be considered based on the aggregate effect of all of the unobservable inputs.

Although IFRS 7 does not provide any insights on techniques to assess significance, as already noted, it does set out the relevant factors against which it should be judged. The hierarchical analysis should be determined based on what is significant to “the fair value measurement in its entirety”. For example, consider a free-standing, long-dated option for which implied volatility is unobservable. As noted above, volatility would typically be significant to the overall fair value of the option, and, accordingly, the measurement would be classified as level 3. Now assume the same long-dated option is embedded in a structured note that has a large balance sheet value. Although the uncertainty over the valuation of the embedded option is identical to that of the free-standing derivative, when considered solely from a balance-sheet perspective, the effect of the unobservable volatility may not be significant to the fair value measurement of the structured note in its entirety.

Entities may need to repeat the assessment of significance as the sensitivity of an instrument to an input may change over its life. Using the above example of a long-dated OTC equity option, as the option moves away from an at-the-money valuation (or simply through passage of time), the valuation may become less sensitive to certain inputs (such as volatility) and inputs that were deemed significant at one point in time may no longer be significant to the overall fair value. This input would then no longer be considered in determining where in the fair value hierarchy the entire measurement falls.

Entities should have a documented policy with respect to their approach to determining the significance of unobservable inputs on its fair value measurements of instruments and that policy should be applied consistently.



## 5. Level 1 inputs

In accordance with IFRS, a published price quotation in an active market is the best estimate of fair value. Therefore, an entity must use the published price quotation whenever available. Quoted prices in active markets should not be adjusted when determining the fair value of assets and liabilities that are identical to those to which the quotes pertain, as the Board believes these prices provide the most reliable evidence of fair value.

## 6. Inputs that cannot be classified as level 1

There are a number of situations where the instrument cannot generally be classified as level 1, in our view, but should typically be in level 2 or 3.

### 6.1 Over-the-counter derivative contracts

Given their nature, we would not normally expect that OTC derivative contracts are classified as level 1 measurements in the fair value hierarchy disclosures under IFRS 7. An OTC derivative contract is a unique bilateral contract between two counterparties for which quoted prices are not continuously available. Although paragraph AG 73 of IAS 39 *Financial Instruments: Recognition and Measurement* states that an instrument is deemed to be quoted in an active market if its valuation depends only on inputs into a valuation technique that are quoted in an active market (such as swap rates), this guidance does not appear in the amended IFRS 7, which focuses only on whether the price is quoted.

### 6.2 Alternative pricing methods

When an entity holds a large number of similar assets and liabilities for which quoted prices exist, but those quoted prices are not easily accessible for each individual asset and liability, entities may use alternative pricing methods that do not rely exclusively on quoted prices (e.g., matrix pricing), as a practical expedient to ease the administrative burden associated with obtaining quoted prices for each individual instrument. However, if an entity elects to use an alternative pricing method as a practical expedient, the fair value measurement determined under this method would not be considered a level 1 measurement.

### 6.3 Quoted prices that are not representative of fair value

In certain situations (primarily related to significant events that occur on the measurement date, but after the close of trading), a quoted price in an active market may not faithfully represent the fair value of an asset or liability at the measurement date. In such situations, entities may make an adjustment to the quoted price in order that the fair value measure reflects this new information. However, if an adjustment is made to the quoted price, the fair value measurement would no longer be considered a level 1 measurement.

An entity's valuation policies and procedures should address how these "after-hour" events will be identified. In addition, controls should be put in place to ensure that any adjustments to quoted prices are in accordance with the relevant measurement guidance and applied in a consistent manner.



## 7. Level 2 inputs

Level 2 inputs include quoted prices (in non-active markets or in active markets for similar assets or liabilities), and inputs other than quoted prices that are observable, for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices). In our view, 'indirectly observable' as used in IFRS 7 is equivalent to the concept used in ASC 820 of US GAAP, that the input can be 'corroborated' by observable market data.

Inputs which would otherwise be categorised as level 3 in the fair value hierarchy, may be categorised as level 2 if they can be corroborated by observable market data. Level 2 inputs should be observable (either directly or indirectly, such as through corroboration with market data) for substantially the full contractual term of the asset or liability being measured.

### 7.1 Corroboration of level 2 inputs

IFRS does not provide detailed guidance on the application of statistical techniques, such as regression or correlation, which could be used to substantiate inputs that are not directly observable in the market. However, the lack of any specific guidance or "bright lines" for evaluating the validity of a statistical inference by the IASB should not be construed to imply that the mere use of a statistical analysis (such as linear regression) would be deemed valid and appropriate to support level 2 classification. Any statistical techniques used should be validated for statistical soundness, i.e., they must support the assumption that the observable input has predictive validity with respect to the unobservable input.

An example of a substantiated level 2 input is for a three-year equity option, where the implied volatility can be derived through a two stage process: (i) prices for a two-year option on the shares are observable; and (ii) the extrapolation of the implied volatility from two to three years can be corroborated, for instance, from observable implied volatilities for three-year options on comparable entities' shares (provided that there is an established high correlation of the two-year implied volatilities of the various entities' share prices).

### 7.2 Pricing services and broker quotes

Information provided by third-party pricing services could potentially be classified in any one of levels 1, 2, or 3, depending on its source and the type of instrument being measured. For example, pricing services may provide quoted market prices (e.g., closing prices) for financial instruments traded in active markets; these prices would be deemed level 1 measurements. Alternatively, a pricing service may provide an entity with consensus pricing information (e.g., information obtained by polling dealers for indications of mid-market prices for a particular asset class). We believe that the non-binding nature of consensus pricing and the fact that it is determined based on indications, rather than observable transactions, would generally result in its classification as level 3 information, assuming no additional corroborating evidence. Pricing services may also use models to determine values for certain asset classes. The level at which these instruments is classified will depend on the observability of the inputs used in the model. Therefore, companies that make use of pricing services will need to gain an understanding of the sources of information and methods used in the price quotes provided by these services in order to determine how the assets or liabilities would be classified in the fair value hierarchy.

The use of a third-party pricing service (or third-party valuation specialist) does not diminish management's ultimate responsibility for the fair value measurements (and related disclosures) reported in the entity's financial statements.

Similarly, the level within the hierarchy at which a quoted price obtained from a broker will be classified depends on the nature of the quote. In certain broker markets, firm quotes are disclosed and an entity has the ability to execute a transaction at the quoted price. Depending on the level of activity in these markets, these quotes may be deemed to be either level 1 or 2. However, in instances where an entity has to solicit a quote from a broker, the quotes are often non-binding and may include a disclaimer that the broker will not be held to that price in an actual transaction. On their own, we believe non-binding quotes would generally represent a level 3 input. In addition, when the quote includes explanatory language or a disclaimer, the entity should assess whether the quote is an appropriate estimate of fair value or whether an adjustment is needed.



### 7.3 Adjustments to level 2 inputs

Given the nature of level 2 inputs, in many circumstances, it may be appropriate for an entity to make adjustments to these inputs. For example, an entity would adjust the quoted price from an active market for a similar asset to account for any differences between the asset to which the quote relates and the actual asset being measured. If the adjustment is significant to the fair value measurement in its entirety and is based on unobservable data, the entire measurement would be considered a level 3 input.

### 7.4 Day one profit

Paragraph AG 76 of IAS 39 states that the best evidence of fair value of a financial instrument at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable transactions or is “based on a valuation technique whose variables include only data from observable markets”. If the valuation uses unobservable data, then the day one profit cannot be recognised. It should be noted that the quoted phrase does not make use of the word ‘significant’ but, in practice, entities often defer day one profit only where the effect of the unobservable input is significant to *that profit*. This contrasts with the new IFRS 7 definition of a level 3 valuation, where unobservable inputs are significant to the value of the instrument *in its entirety*, i.e., based on the balance sheet value. Consequently, it is possible for an instrument to be classified in level 2 even if a day one profit cannot be recognised.

## 8. Level 3 inputs

IFRS permits the use of unobservable inputs to measure fair value in situations where observable inputs are not available. Unobservable inputs that are significant to the fair value measurement will result in the entire fair value measurement being categorised in level 3.

## 9. Illustrative disclosures

Appendix 2 contains an example of the disclosure in the illustrative financial statements of Good Bank (International) Limited for reference purposes.

# Appendix 1

## Examples of financial instruments and their levels in the fair value hierarchy

Instrument characteristics	Considerations	Conclusion
1. A unit in an investment fund quoted in an active market, whose investments are classified at levels 2 and 3 in the fair value hierarchy.	The fund's units are quoted in an active market. The valuation of the fund's assets and liabilities is not relevant.	Level 1
2. A unit in a non-quoted investment fund which only invests in financial assets quoted in active markets.	Although the fund's investments are quoted, the fund's own units are not. Therefore, it does not meet the definition of a level 1 instrument. This is the case even when the fair value of the fund's unit is determined to be a proportion of the net asset value of the fund.	Generally level 2. If significant liquidity discounts are applied (e.g., when the fund has redemption gates or lock-up periods) the effect of the adjustments may put the fair value in Level 3.
3. A liquid OTC 10-year plain vanilla interest-rate swap traded in an active market.	Given their nature, it is not expected that OTC derivative contracts will be classified as level 1.  Depending on the observability of the inputs used, these measurements would represent either level 2 or level 3 instruments. If traded in an active market, it is likely to be level 2.	Probably level 2
4. An instrument for which there is currently no active market. An observable, recent transaction took place in this particular instrument. This was sufficiently close to the balance sheet date that no adjustments were deemed necessary to calculate the fair value.	Whether a transaction was sufficiently 'recent' will depend on market conditions. Even if there is very little market volatility, in our view, they should generally not be older than 14 days . It is important that no events have happened to the issuer, the instrument or the environment since it was traded, that would indicate a possible, subsequent change in fair value.	Level 2
5. An instrument for which there is currently no active market. An observable recent transaction took place in this particular instrument. Because of events between the date of the transaction and the balance sheet date, adjustments are necessary to calculate the fair value. The adjustments are considered to be <b>not</b> significant.	Whether a transaction was sufficiently recent will depend on market conditions. Even if there is very little market volatility, in our view, the transactions should generally not be older than 14 days . Although events have happened to the issuer, or the instrument or the environment in which the instrument trades, that require some form of adjustment to the transaction price, this adjustment is not significant.	Level 2
6. As per example 5 except that the adjustments <b>are</b> significant.		Level 3



7. An instrument for which there is currently no active market. An observable transaction took place on the balance-sheet date in a similar instrument. Although the instrument is similar, it is not the same. Therefore, adjustments are necessary to calculate the fair value. The adjustments are considered to be <b>not</b> significant.	Although the transaction in the instrument should be adjusted for differences between the instruments, this adjustment is not significant.	Level 2
8. As per example 7 except that the adjustments <b>are</b> significant.		Level 3
9. An instrument traded in an active market for which one or more market participants provide a binding price quotation on the balance sheet date.	A binding quote is a bid price and is evidence of the amount for which an asset could be exchanged, between knowledgeable, willing parties, in an arm's length transaction.	Level 1
10. An instrument for which there is currently no active market. A consensus pricing mechanism (e.g., Totem) is used to determine its fair value.	The consensus pricing mechanism gets its inputs from market participants. These participants may determine the fair value by using models with unobservable inputs. The quotes that the participants provide to the consensus pricing mechanism are not binding bids and are not necessarily supported by prices from observable current market transactions.	Usually level 3 unless evidence can be provided that the quotes are supported by observable transactions or inputs, in which case, level 2.
11. An instrument whose fair value is provided by a pricing service (e.g., IDC/JJKenny) or a vendor (e.g., Reuters/Bloomberg), or broker or custodian.	For these services, it is important to understand the methodology employed by the pricing service or vendor that provides the data. The conclusion depends on the methodology and liquidity of the market in which the financial asset/liability is traded. Proper care has to be given before it can be concluded that the data is observable.	Depending on facts and circumstances, the conclusion could be any of the levels. If the price provider uses only transaction prices of transactions occurring in an active market on the valuation date of the same instrument then it would be in level 1. If the price provider uses a modelling technique to determine the values, how the inputs to such model were determined should be assessed. If these inputs can be proven to be observable, the instrument would be in level 2, if the inputs are unobservable, it would be in level 3. If the price provider uses historical trades to determine fair value, then proper care should be given to how recent the trade was. The same assessment should be made for a price obtained from a vendor as if the entity had determined the price itself.



12. An instrument for which there is currently no active market. The entity obtains non-binding quotes from different sources.	If only non-binding quotes are used then these would not be regarded as 'observable' transactions.	Level 3, unless evidence can be provided that the quotes are supported by observable transactions or inputs, in which case, level 2.
13. An instrument for which there is currently no active market. The entity uses a valuation model which is accepted in the market/industry. Some or one of the inputs to the model are unobservable. The model is calibrated to an index with recent transactions (for example the ABX index), however, adjustments need to be made to reflect differences between the characteristics of the index and the instrument to be valued. The adjustments are <b>not</b> significant.	An assessment is needed about whether the unobservable inputs can be proven with other observable variables. The index is an observable proxy for the instrument as long as necessary adjustments are not significant. Otherwise it would be in level 3.	Level 2
14. As per example 13, except that the adjustments <b>are</b> significant.		Level 3
15. An instrument for which there is currently no active market. The entity uses a valuation model that is accepted in the market/industry. A significant input to the model is a credit spread based on historical default statistics and the credit rating assigned by an agency to the instrument.	Credit ratings are not normally evidence of market transactions.	Level 3
16. An equity instrument for which there is currently no active market. The entity uses a valuation model which is accepted in the market/industry based on a price/earnings ratio for similar entities. No statistical technique is used to corroborate.	Although the calculation of a price/earnings ratio is usually based on market transactions, the application of the ratio is not evidence of market transactions in the same instrument.	Level 3
17. A loan or debt instrument for which no active market exists. The entity uses a model to calculate its fair value. The model uses discounted cash flows based on the risk-free interest rate plus a credit spread. The credit spread is significant but is, in itself, not observable for that instrument, e.g., because the entity does not have quoted debt.	In this example, the credit spread is considered significant. Therefore, the conclusion is Level 3. If the credit spread is insignificant, then the conclusion could be level 2.	Level 3



<p>18. An instrument for which no active market exists. The company recently entered into an off-setting transaction with a third party.</p>	<p>An off-setting transaction can constitute evidence of an observable market transaction, when it can be demonstrated that the offsetting transaction nullifies substantially all the price risk of the proportion of the instrument offset and the proportion is significant. In cases such as derivatives, where the counterparty's credit risk is also based on observable inputs, then it can be concluded that all input data are observable. If the above conditions are not met, then the instrument would be included in level 3.</p>	<p>Level 2</p>
<p>19. An instrument for which a model is applied to calculate fair value. For one input variable, the company interpolates between two observable variables to calculate the variable to include in the model for this particular instrument.</p>	<p>Interpolation techniques may be used, but must be supported by historical observations and must be expected to be reliable. The use of interpolation must be applied with appropriate care and judgment. For example, if the two observable variables are too far apart, the interpolation may involve a considerable level of estimation, in which case the conclusion would be level 3.</p>	<p>Level 2</p>
<p>20. As per example 19, except that an extrapolation technique is being used. The extrapolation is significant and it is not possible to corroborate the extrapolated input with market observable data.</p>	<p>A significant component of the price of a derivative may be dependent upon extrapolated data in the absence of observable market data.</p> <p>Level 2 inputs should be observable (either directly or indirectly through corroboration with market data) for substantially the full contractual term of the asset or liability being measured. Therefore, extrapolating long-term inputs from short-term observable market data would not represent a level 2 input.</p>	<p>Level 3</p>

# Appendix 2

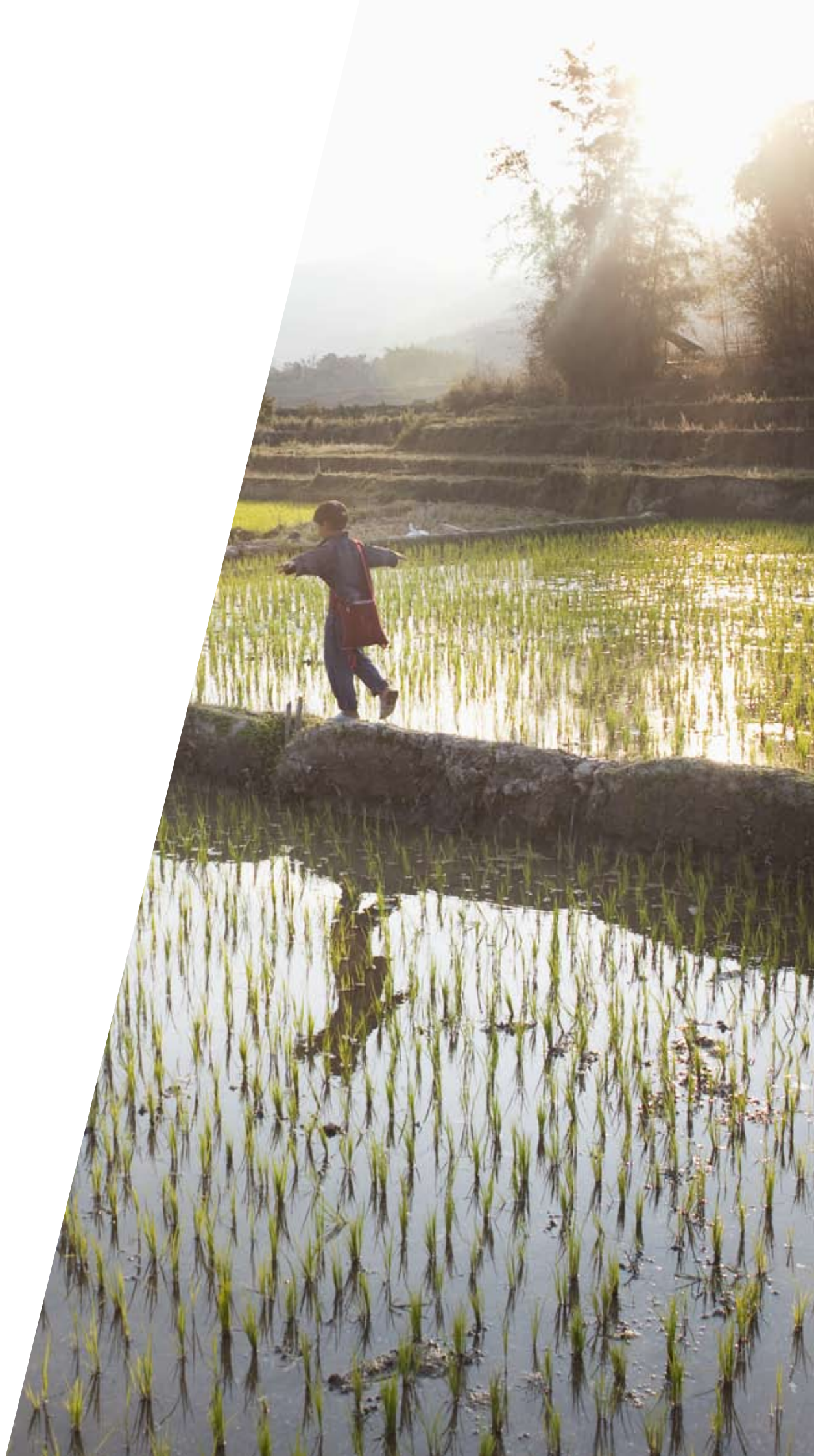
## Illustrative disclosures required by IFRS 7

### Figure 1

The following example from Good Bank illustrative financial statements shows the hierarchical classification of financial assets and liabilities measured at fair value.

### Fair value of financial instruments *continued*

31 December 2008	Level 1 \$ million	Level 2 \$ million	Level 3 \$ million	Total \$ million
<b>Financial assets</b>				
Derivative financial instruments				
Interest rate swaps		3,196	167	3,363
Currency swaps	-	1,347	152	1,499
Forward foreign exchange contracts	150	668	7	825
Interest rate options	28	785	43	856
Credit default swaps	-	495	20	515
	<u>178</u>	<u>6,491</u>	<u>389</u>	<u>7,058</u>
Other financial assets held-for-trading				
Government debt securities	5,728	-	-	5,728
Debt securities issued by banks	265	545	435	1,245
Asset backed securities	-	151	452	603
Other debt securities	43	104	519	666
Quoted equities	2,004	125	-	2,129
	<u>8,040</u>	<u>925</u>	<u>1,406</u>	<u>10,371</u>
Financial assets designated at fair value through profit or loss				
Loans and advances to customers	-	755	511	1,266
Financial investments available-for-sale				
Quoted investments				
Government debt securities	6,361	-	-	6,361
Other debt securities	1,455	150	-	1,605
Equities	422	-	-	422
Unquoted investments				
Debt securities	-	2,996	670	3,666
Equities	-	-	140	140
	<u>8,238</u>	<u>3,146</u>	<u>810</u>	<u>12,194</u>
	<u>16,456</u>	<u>11,317</u>	<u>3,116</u>	<u>30,889</u>
<b>Financial liabilities</b>				
Derivative financial instruments				
Interest rate swaps	-	3,881	120	4,001
Currency swaps	-	1,404	130	1,534
Forward foreign exchange contracts	424	751	8	1,183
Interest rate options	78	864	56	998
Credit default swaps	-	17	4	21
Equity swap and options	-	-	12	12
	<u>502</u>	<u>6,917</u>	<u>330</u>	<u>7,749</u>
Other financial liabilities held for trading				
Short positions in quoted equities	2,667	-	-	2,667
Short positions in quoted debt securities	1,292	-	-	1,292
	<u>3,959</u>	<u>-</u>	<u>-</u>	<u>3,959</u>
Financial liabilities designated at fair value through profit or loss				
Structured notes	-	3,585	-	3,585
	<u>4,461</u>	<u>10,502</u>	<u>330</u>	<u>15,293</u>



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