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International
Accounting Standards
Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **November 2008, London**
Project: **Fair Value Measurement of Financial Instruments in Inactive Markets: Determining the Discount Rate (Agenda Paper 7D)**

Introduction and background

1. On October 28 the IFRIC received a letter describing a proposed approach to the determination of the discount rate for present value computations in inactive markets in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. That letter is included as Appendix A. (As the submitter published the letter on its website and conducted media interviews regarding the submission, the staff concluded that the normal restrictions regarding the confidentiality of submissions was not relevant in this case.)

2. The letter did not specifically request that any issue be added to the IFRIC's agenda and did not provide an analysis of the proposed approach against the IFRIC's agenda criteria. However, given the nature of the issue, the staff concluded that the request might be urgent and should therefore be considered at the November IFRIC meeting. We apologise for the late posting of this paper as a consequence of that decision.

3. This paper sets out the staff's analysis of whether this issue should be added to the IFRIC's agenda.

Staff analysis

4. The staff notes that the submission proposes an approach to determining the components of a discount rate to be used to determine the fair value of a financial instrument by using a valuation technique when a market is inactive. In particular, it deals with the determination of credit spreads and especially liquidity spreads when these components are not observable in the market.

5. The staff also notes that the issue of determining fair values in inactive markets has been the subject of a considerable amount of recent activity by the IASB and the staff of the fair value measurement and financial instruments projects. The following documents have been published or are in process:

   (a) On 16 September as a first step in developing guidance on the application of fair value in illiquid markets, the IASB staff released a draft document emanating from discussions of its Expert Advisory Panel. That document sets out how experts measure and disclose fair values of financial instruments in inactive markets. The Panel met on 10 October to discuss comments received on the draft document.

   (b) On 30 September the US Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) staffs issued a clarification of the US standard FAS 157 *Fair Value Measurement*s. The IASB issued a press release on 2 October indicating that its staff considers this clarification consistent with IFRSs.

   (c) As a result of the Panel meeting, on 14 October the IASB issued the press release noted in the submission. The press release noted that the Panel agreed to emphasise existing guidance within International Financial Reporting Standards (IFRSs) that using the entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. The final Panel document was published on 31 October as part of IASB staff educational guidance.

6. In addition, the IASB and FASB have agreed to a joint approach to dealing with reporting issues arising from the global financial crisis. The Boards have emphasised the importance of working cooperatively and in an internationally coordinated manner to consider accounting issues emerging from the global crisis. The Boards also emphasised the role of high quality financial reporting in helping enhance confidence in the financial markets by responding in a timely manner that improves transparency and provides greater global consistency in financial reporting.

7. As part of their joint response, the Boards will establish a high-level advisory group. In November, while the advisory group is being established, the IASB and the FASB will organise three roundtables—one each in Asia, Europe, and North America. The purpose of these public roundtables is to gather input on reporting issues emanating from the current global financial crisis—including responses by governments, regulators and others. This should enable the Boards to act rapidly and the advisory group, once established, to advance its deliberations efficiently.

Staff Recommendation

8. The staff has assessed the issue raised in the submission against the IFRIC agenda criteria as follows:

    (a) Given current market conditions, the issue is widespread and of practical relevance.

    (b) It is not certain whether there is diversity in practice. The educational guidance issued by the IASB including the Expert Advisory Panel document emphasises the existing requirements of IAS 39. These requirements are outlined clearly in the submission. Therefore the staff believes that any diversity observed in practice is likely to arise from entities exercising the judgement the Panel emphasises is necessary in current market conditions to achieve the objectives of IAS 39.

    (c) The issue appears to be relatively narrow in scope. However, it could have significant implications for the determination of fair values. In the staff’s view, this is not a matter for interpretation. The issue raised is how to apply the requirements of a standard when the objective is clear.

(d) The issue relates to current high priority Board activities. It is directly relevant to the Board's existing agenda project to provide fair value measurement guidance. An exposure draft on this project is expected in the first half of 2009. In addition, the issue relates directly to the subjects to be discussed at the joint IASB/FASB roundtables to be held in the next few weeks.

9. The staff recommends that this issue not be added to the IFRIC's agenda. The staff believes that the issue should be included for discussion at the roundtables mentioned above and that any additional guidance determined to be necessary should be provided as a result of the Board's joint activities with the FASB and its fair value measurement project.

10. The staff has set out proposed wording for the tentative agenda decision in Appendix B.

Questions for the IFRIC

11. Does the IFRIC agree with the staff recommendation?

12. Does the IFRIC have any comments on the drafting of the tentative agenda decision?

[Appendix B is omitted from this observer note]

APPENDIX A

IDW

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Mr Robert P. Garnett
Chairman of the International Financial
Reporting Interpretations Committee
30 Cannon Street
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Düsseldorf, 27 October 2008
482/468

Dear Mr Garnett

Fair Value Measurement of Financial Instruments in Inactive Markets: Determining the Discount Rate for Present Value Computations (IAS 39)

Occasioned by the extreme developments within the financial markets during the past few weeks, the IASB and the FASB have recently discussed a number of accounting and reporting issues arising in the context of the global financial crisis, including the application of the fair value hierarchy of IAS 39 and the fair value measurement of financial instruments in markets that are no longer active. These issues have become even more important since the markets for plain vanilla bonds and other standard financial instruments have become inactive for longer periods, as has been experienced on markets for (certain) securitisation instruments. The inactivity of a market for a particular financial instrument is strongly evidenced by both a significant widening of the bid-ask-spread in the brokered markets for that financial instrument (indicative prices only), and no trading volume, respectively a significant decrease in the volume of trades relative to historic levels as well as other relevant factors (see IASB's press release of 14 October 2008, which refers to guidance previously issued in a FASB Staff Position). An inactive market can still exist, despite the incidence of isolated transactions. In such situations, however, the preparer needs to justify why the assumption of an illiquid market is appropriate.

In an active market, the best evidence of fair value is quoted prices (IAS 39.48A). If the market for a financial instrument is not active (illiquid), an entity

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establishes fair value by using a valuation technique. Valuation techniques include discounted cash flow analysis (IAS 39.AG74). Indeed, such discounted cash flow techniques are becoming increasingly relevant because, under such conditions as have been faced recently, it is often neither possible to deduce fair value from recent arm's length market transactions in the particular financial instrument nor to draw upon current fair values of other instruments that are substantially the same.

One crucial aspect of applying discounted cash flow techniques is the determination of the discount rate for present value computations in inactive markets. As you are certainly aware, this topic has been the subject of widespread debate between preparers of financial statements, auditors and other interested parties.

After intense and comprehensive deliberation, we have developed a proposal as to how to adequately understand IAS 39 in this context, which we explain below. We have discussed this proposal with the German Federal Government, the BaFin (the German securities, banking and insurance supervisor) and the Deutsche Bundesbank (German Central Bank), all of whom support the approach.

Discounted cash flow models usually forecast cash flows generated by the financial instrument and discount these cash flows using a term and risk adequate yield curve. This yield curve consists of three major components, i.e. the basic risk-free interest rate, the credit spread and the liquidity spread. These spread components have to be distinguished between components that are observable on the market and components that are not observable on the market.

In liquid markets the credit spread, i.e. the premium over the basic interest rate for credit risk, may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings (IAS 39.AG82(b)). In illiquid (inactive) markets valuation techniques that comprise discounted future cash flows and related credit risk are used to arrive at an appropriate determination of fair value.

The liquidity spread basically reflects supply and demand in those financial instruments. In active markets the liquidity spread can be derived from internal rates of return and is observable. In illiquid markets the liquidity spread is not observable because it is neither quoted separately (e.g. by a broker or pricing service agency) nor indirectly deducible from transaction prices.

According to IAS 39.AG78, subsequent to initial recognition, an entity may not have information from recent transactions to determine the appropriate spread over the basic interest rate for use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed on initial recognition. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

Applying this principle to the case of a liquidity spread that is no longer observable on the market, an entity uses, as a starting point, the latest observable amount of this spread component (i.e. when the market was last deemed to be active). Subsequently, when evidence of an adverse change exists, this spread component has to be increased by a premium which must be determined on the basis of both the nature of the specific instrument and the relevant market conditions. However, the maximum amount of this liquidity risk may not exceed the liquidity risk of a non-tradeable loan or receivable which, except in terms of its tradeability, is comparable to the security to be measured.

We support our proposal as to how to adequately understand IAS 39 as follows: In our opinion, the concept underlying IAS 39's fair value hierarchy is that (objective) price information obtained from the market is more relevant and reliable than (subjective) management estimates. However, this concept does, at the same time, acknowledge that market information is only superior as long as markets are functioning properly, at least to a certain degree. Consequently, the fair value hierarchy also requires a (successive) transition from a market-based to a model-based valuation when markets are becoming inactive and no longer provide useful inputs for one or more parameters affecting the value of a financial instrument at the measurement date (such as interest rate spreads containing a credit and liquidity risk element). In such circumstances, model-based valuation should aim to calculate the value of a financial instrument that could reasonably be expected to be the price market participants would agree upon, were they acting in a rational manner.

According to IAS 39.AG75 the objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. The reference to "normal" business considerations should not be misinterpreted as

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implying that no "stressed" business considerations may be taken into account. Rather, in our view, the reference to "normal" business considerations serves firstly to distinguish between "normal" market conditions on the one hand and forced transactions, involuntary liquidations, distress sales on the other, and secondly to eliminate from the valuations, market behaviour that is clearly not indicative of fair value.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter. Moreover, we would be pleased to provide IFRIC with a more detailed in-depth analysis, which would also include practical issues that need to be addressed in the model-based valuation described above.

Yours sincerely

Klaus-Peter Naumann
Chief Executive Officer