

**International Accounting
Standards Board (IASB)**

30 Cannon Street
London EC4M 6XH | UK

Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
info@ifrs.org

www.ifrs.org

4 August 2011

Steven Maijoor, Chair
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Sent via email

Dear Mr Maijoor,

Accounting for available-for sale (AFS) sovereign debt

There have been indications in the market that some European companies are applying the accounting requirements for fair value measurement and impairment losses in a way that seems to differ from the objective of IAS 39 *Financial Instruments: Recognition and Measurement*. This is evident particularly in their accounting for distressed sovereign debt, including Greek government bonds. Those indications have now been confirmed by recently published financial reports, which show inconsistent application of IAS 39 across Europe. This is a matter of great concern to us.

We are aware that, as an accounting standard-setter, the IASB does not have the authority to ensure compliance with International Financial Reporting Standards (IFRSs). However, the IASB and ESMA have a mutual interest in ensuring the highest quality in the application of IFRSs. Although we do not usually comment on how our standards are applied, because this case demonstrates visibly inconsistent application, we believe that it is appropriate for us to bring this matter to your attention.

I thought it would be helpful to provide you with some information about the objective of fair value measurement in IAS 39 and the use of models when the market for a particular financial instrument is not active. This letter does not address financial assets classified as held-to-maturity or loans and receivables.

In October 2008 the IASB staff published a report summarising the discussions of our Fair Value Expert Advisory Panel, which was set up in response to the recommendations made by the Financial Stability Board to address the measurement and disclosure of financial instruments when markets are no longer active. That report was well-received and was found to be helpful in the last financial crisis. Many respondents to our exposure draft on fair value measurement indicated that they found it consistent with the fair value measurement concepts in IAS 39 (as well as in US generally accepted accounting principles, or GAAP), which are described in this letter. That guidance is now in IFRS 13 *Fair Value Measurement*, which we issued in May.

Fair value of AFS financial assets

AFS financial assets are measured at fair value with changes in fair value measurement presented in other comprehensive income. However, as you know, IAS 39 requires a company to recognise any impairment loss in profit or loss when there is objective evidence that those financial assets are impaired. If it is determined that those assets are not impaired, the company continues to recognise the decline in fair value in other comprehensive income. If it is determined that those assets are impaired, the company recognises the accumulated decline in fair value in profit or loss. In other words, the impairment calculation for AFS financial assets is based on the fair value of the assets.

It appears that some companies are not following IAS 39 when determining whether the Greek government bonds that they classify as AFS are impaired. They are using the assessed impact on the present value of future cash flows arising from the proposed restructure of those bonds, rather than using the amount reflected by current market prices as required in IAS 39.

In addition, some companies holding Greek government bonds classified as AFS have stated that they are relying on internal valuation methodologies, rather than on market prices, to measure the fair value of the assets as at 30 June 2011. The reason generally given for using models rather than market prices is that the market for Greek government bonds is currently inactive (and therefore, in their view, does not provide reliable pricing information).

Determining whether a market is active

In measuring fair value, IAS 39 prioritises the use of quoted prices in active markets over the use of valuation models developed using internal assumptions.

IAS 39 describes an active market for a financial instrument as one in which ‘quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm’s length basis’. It is important to note that the description of an active market does not focus solely on trading activity. That is because when measuring fair value, the issue is not about the level of market activity *per se*, but about whether an observed transaction price represents fair value.

Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices varying significantly over time or among market participants, or the prices not being current. However, those factors alone do not necessarily mean that a market is no longer active. A company cannot ignore observable transaction prices when it is clear that market participants are regularly entering into transactions for the same or similar financial assets, even if they are doing so less frequently than they have in the past.

Although the level of trading activity in Greek government bonds has decreased, transactions are still taking place. IAS 39 is clear that unless there is evidence that the prices in those transactions do not represent fair value (for example, because those transactions are forced or because they require significant adjustment because of timing differences between the transaction date and the measurement date, which are matters of judgement and depend on the facts and circumstances), the observed transactions prices should be used to measure fair value.

Using models when measuring fair value

The objective of a fair value measurement, whether using an observed market price or a valuation model, is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date. In other words, the goal is to arrive at a current market price. This can be done by using an observed price, or by replicating a market price using a valuation model. In addition, the objective of the measurement is the same *irrespective* of current market conditions.

Even when a model is used to measure fair value, that model must reflect current market conditions (including those as evidenced by observable transaction prices) and it should include appropriate adjustments that market participants would make for credit and liquidity risks. Furthermore, the model must maximise the use of relevant observable inputs (eg market data) and minimise the use of unobservable inputs (eg the company's own assumptions). A company cannot ignore relevant market data (including observable transaction prices) when it is clear that market participants would use that data in determining the price at which they would be willing to enter into a transaction for the financial asset.

It would therefore not be in accordance with either the requirements in, or the intent of, IAS 39 to measure a loss on government bonds classified as AFS financial assets solely by assessing the present value of the future cash flows arising from a proposed restructure of those bonds. It is hard to imagine that there are buyers willing to buy those bonds at the prices indicated by the valuation models being used. In my view it is therefore difficult to justify that those models would meet the objective of a fair value measurement.

Yours sincerely



Hans Hoogervorst, Chair