IAS 39 Financial Instruments: Recognition and Measurement (March 2009)

Fair value measurements of financial instruments in inactive markets: determining the discount rate

The IFRIC received a submission containing a proposal on how a discount rate should be determined when fair value is established using a valuation technique. The submission noted that both the credit spread and liquidity spread components of the discount rate might not be observable in inactive markets. The submission suggested that, in such circumstances, the liquidity spread should not exceed that of a non-tradable loan or receivable which is comparable to the security being measured and that a model-based valuation should aim to calculate the value of a financial instrument that market participants would agree on if they were acting in a rational manner.

The IFRIC noted that IAS 39 states that the objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arms length exchange motivated by normal business considerations. Therefore, that measurement incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Accordingly, the IFRIC concluded that any suggestion that a valuation technique should consider factors differently from the way a market participant would be expected to consider them so as to arrive at a price that is different from the price a market participant would determine, as appeared to be the case in the approach proposed in the submission, would not be consistent with IAS 39.

After its tentative agenda decision was published, the IFRIC received a further letter from the authors of the submission clarifying that:

- it was not their objective or intention to suggest that within fair value computations particular factors should be adjusted away from a market participant's view.
- the current liquidity risk of a comparable non-tradable loan or receivable is one indicator that management could use in applying judgement when determining a liquidity spread rather than as an absolute limitation of liquidity risk.
- forced transactions, involuntary liquidations or distress sales are not relevant transactions for the purpose of determining fair value and, to the extent that their effect on a market price can be identified, that effect would be eliminated.

The IFRIC also noted that any guidance it could provide would be in the nature of implementation guidance rather than an interpretation. In addition, the IASB has published the report of its Expert Advisory Panel which explains how experts measure and disclose the fair values of financial instruments in inactive markets and a staff summary on the use of judgement to measure those values when markets are no longer active. The issue relates directly to the subjects that were discussed at the joint IASB/FASB round tables held in November and December. In the IFRIC's view, any new or amended guidance that is necessary should be provided as a result of the Board's joint activities with the FASB and its fair value measurement project.

Therefore the IFRIC decided not to add this issue to its agenda.