Financial Accounting Standards Board

International Accounting Standards Board

401 Merritt 7, PO Box 5116, Norwalk, CT 06856, USA
Tel: +1 203 847 0700
Fax: +1 203 849 9714
Website: www.fasb.org

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Website: www.iasb.org

INFORMATION FOR OBSERVERS

Board Meeting: **20 October 2008, Norwalk**

Project: **Fair Value Measurement**

Subject: **Expert Advisory Panel Update (Agenda Paper 5B)**

Purpose of this paper

1 This paper summarises the activities of the expert advisory panel about the measurement and disclosure of financial instruments in markets that are no longer active.

Background

2 The recent illiquidity in some markets has led to difficulties in establishing the fair value of some financial assets and financial liabilities (financial instruments). The reduction in liquidity means that prices or inputs to models which previously have been readily observable are no longer observable. As a result, entities have had to switch from valuing financial instruments at quoted market prices in active markets or using models containing mainly observable inputs, to valuing instruments with models that use a greater number of unobservable inputs.

3 Following recent financial turmoil, the Financial Stability Forum (FSF) published a report to the G7 group of Finance Ministers and Central Bank Governors in April 2008 making recommendations for Enhancing Market and Institutional Resilience.

4 The report was the result of collaboration by the main international bodies and national authorities in key financial centres, including representatives from the IASB. It set out 67 recommendations, which the G7 endorsed on 11 April 2008. Of the recommendations, two call for enhancements to fair value measurement guidance and disclosures:

> **Recommendation III.5** The IASB will strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations.
>
> **Recommendation III.6** The IASB will enhance its guidance on valuing financial instruments when markets are no longer active. To this end, it will set up an expert advisory panel in 2008.

5 In May 2008 the IASB formed and consulted with an expert advisory panel in response to the above recommendations. The panel met seven times between June and August 2008 to discuss measurement and disclosure issues encountered. As a result of those discussions, the staff prepared a draft report summarising practices that experts use for measuring and disclosing financial instruments when markets are no longer active. The draft was posted on the IASB website for interested parties to provide feedback.

6 The panel last met on 10 October 2008 to discuss the feedback received on the draft document. A final document will be posted on the IASB Website in October 2008 and will be included with the financial instruments volume educational materials (expected to be published in November 2008).

Objectives of the panel

7 The panel's role was threefold:

a to identify valuation and disclosure issues the panel members have encountered in the current market environment;

b to discuss the solutions applied in practice; and c to identify any improvements to the related disclosures.

8 The panel members' discussions will assist the IASB in deciding what additional guidance and disclosures, if any, might be necessary with regard to the fair value of financial instruments in markets that are no longer active. The discussions also will be useful for future standards, including the forthcoming fair value measurement standard. The discussions have also provided helpful input for possible amendments to IFRS 7 *Financial Instruments: Disclosures*.

9 It was not within the remit of the panel to discuss whether fair value is an appropriate measurement basis for a particular financial instrument or class of financial instruments. The IASB is addressing this in its work on financial instruments and has published a discussion paper *Reducing Complexity in Reporting Financial Instruments*, inviting respondents to comment by 19 September 2008.

Overview of output

10 The IASB staff prepared a draft document summarising the discussions of the panel. That document was posted on the IASB Website on 16 September 2008 for interested parties to provide feedback on its contents. The document has two parts:

11 **Part 1: Measurement**:

a reminds readers of the objective of fair value measurement and summarises the requirements of IAS 39 *Financial Instruments: Recognition and Measurement*;

b describes key issues identified by the panel members; and

c describes some of the approaches they have used to address these issues when measuring the fair values of financial instruments in markets that are no longer active.

12 **Part 2: Disclosure** addresses disclosures about fair value measurement in the light of the credit crisis. The document also summarises the existing disclosure requirements in IFRSs.

13 The draft document is intended to be educational. It only summarises the discussions of the panel members. The document:

a does not represent an official position of the panel member organisations or the representatives from the organisations; and

b is not an official interpretation of IFRSs or any other body of accounting standards, nor does it establish new requirements for entities applying IFRSs or any other body of accounting standards.

What we learned

Measurement

14 The panel meetings suggest that the requirements and guidance in IAS 39 about fair value measurement are generally clear and well understood, and that there is much consistency in the approaches, and thought processes, used to arrive at a fair value measurement.

15 However, this does not mean that entities find it straightforward to apply the requirements in IAS 39 in all cases. For example, some entities, particularly smaller financial institutions and corporate entities, might benefit from education about possible approaches to fair value measurement in markets that are no longer active. Describing how the panel members have dealt with these issues in practice might provide some help and reassurance to those entities.

16 Fair value measurement requires the use of judgement. The facts and circumstances for each instrument are different. The measurement part of the document does not contain detailed examples covering each of the issues raised. This is because it is not the role of a principles-based document, and the panel members advised against it because it could be seen as creating rules for how to perform a valuation and what assumptions should be made. The document, like IFRSs, cannot take into account or solve every situation. Even if we tried to solve every problem, new problems would arise and any documented solutions could quickly become irrelevant.

Disclosure

17 Market practice under IFRS 7 continues to evolve and that some entities prepare disclosures for IFRS 7 with the objective of improving consistency with US GAAP, particularly FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157). For example, in response to requests from users, some

entities are using a hierarchy for fair value disclosures under IAS 39 and IFRS 7 that is similar to that in SFAS 157. Furthermore, users of financial statements need clear and consistent presentation of information about those fair value measurements subject to the greatest uncertainty and subjectivity.

18 The discussions about disclosures provided helpful input for the exposure draft of proposed amendments to IFRS 7, issued on 15 October 2008. The exposure draft proposes amending IFRS 7 to:

a classify and disclose fair value measurements using a clear fair value hierarchy, which is consistent with the hierarchy in SFAS 157. The proposed hierarchy contains the following three levels:

i Level 1: fair values measured using quoted prices in an active market for identical assets or liabilities

ii Level 2: fair values measured using valuation techniques for which all inputs significant to the measurement are based on observable market data

iii Level 3: fair values measured using valuation techniques for which any input significant to the measurement is not based on observable market data.

b require entities to present quantitative disclosures about fair value measurements in a tabular format unless another format is more appropriate to the circumstances.

c for fair value measurement using significant unobservable inputs (Level 3), require a reconciliation from period to period along with a narrative description about any movements between levels of the hierarchy and the reasons for those movements.

d for fair values that are disclosed but not recognised, require an indication of the level of the hierarchy in which the instrument falls.

19 The exposure draft is out for public comment until 15 December 2008.

Process followed

20 As noted above, in May 2008 the IASB formed an expert advisory panel in response to the recommendations in the FSF report. The panel has met seven times since June.

21 In those meetings, the panel members discussed specific valuation and disclosure issues encountered in practice in the current market environment and the resolutions that have been found in practice over the past several months. They discussed examples to illustrate measurement issues and potential disclosures that would be helpful users. The draft document summarises these discussions.

22 The draft document was posted on the IASB Website on 16 September 2008 for interested parties to provide feedback.

Summary of feedback received on draft document

23 The staff received 39 comments on the draft document. Overall, the feedback received was supportive of the publication of the document. Commentators found it to be helpful and educational. Having said that, they raised the following concerns about its contents.

24 Feedback about the **measurement** section:

a Some asked for clarity about whether the draft document is consistent with the press release issued by the SEC Office of the Chief Accountant and FASB staff clarifying fair value accounting dated 30 September 2008, particularly with regard to the use of management’s internal assumptions and forced transactions. Some read the two documents as conflicting with each other. Others think the guidance is the same, but suggest that their tones are different. The IASB staff issued a press release on 3 October stating that the SEC-FASB press release, the expert advisory panel document and the guidance in IAS 39 are consistent.

b Some would like the document to clarify what is meant by ‘fundamental value’.

c Some think the description of forced transactions is too narrow.

d Some would like further clarity about when an entity can use a model in place of observed transaction data. For example, they ask whether an entity can use a model when the market for a financial instrument is considered to be inactive.

Staff comment: We are working on revised wording for the final document to address these comments. The final document will include the example in FASB Staff Position FAS 157-3.

25 Feedback about the **disclosure** section:

a Some are concerned that regulators and auditors will require the disclosures even though the introduction to the document states that they are not mandatory.

b Some would like the document to specify where in the document the additional disclosures suggested should be located (eg in management commentary, management's discussion and analysis, etc.).

Staff comment: We will not address these in the document because the document simply summarises what some panel members and other entities have done in practice. The document clearly states that the disclosures presented are not mandatory to the extent that they are not already required in IFRSs. Determining the location of additional disclosures will depend on each entity's policies and circumstances; it is outside the role of the document to specify where any additional, non-mandatory disclosures are presented.

26 Feedback about the **status** of the document:

a Some are concerned that regulators and auditors will interpret the guidance in the document as being mandatory and that it implies new measurement and disclosure requirements.

b Some think the document should be more explicit about how the guidance in it will be reflected in forthcoming amendments to IFRS 7 and in the fair value measurement project.

Staff comment: The document clearly states that the measurement and disclosure issues presented in the document are intended to be educational and are not mandatory to the extent they are not already required in IFRSs. We will amend the document to clarify which additional disclosures are proposed in the exposure draft to amend IFRS 7, which was issued 15 October. It is too soon to determine specific aspects of the document that will be reflected in the forthcoming exposure draft of an IFRS on fair value measurement.

27 Other feedback **outside the scope** of the document:

a Some suggest that the IASB make changes to the reclassification rules in IAS 39.

b Some suggest making changes to the tainting rules for held-to-maturity financial instruments.

c Some suggest making changes to the impairment rules for available for sale financial instruments.

d Some request a suspension of fair value (mark-to-market) accounting in times of market turmoil.

e Some suggest excluding an entity's own credit risk from the measurement of liabilities.

f Some wonder how the US Government's asset purchase programme will affect fair value measurement.

Staff comment: We will not amend the document to reflect these comments because they are outside the scope of the document and the remit of the panel. The IASB has addressed the point on reclassification by amending IAS 39 on 13 October.

Next steps

28 We will post a final document on the IASB Website based on the feedback received on the draft (see paragraphs 23-27 above) and on discussions at the 10 October meeting about that feedback. We expect to post the final document on the IASB Website in October 2008 and include it in the updated edition of the financial instruments volume educational materials.