Using judgement to measure the fair value of financial instruments when markets are no longer active

An IASB Staff Summary

October 2008

International Accounting Standards Board®

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Introduction

Purpose

1 This document, prepared by the International Accounting Standards Board (IASB) staff, sets out the context for the IASB expert advisory panel report *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. It accompanies, but does not form part of, that report. This document takes into consideration the documents issued recently by the US Financial Accounting Standards Board (FASB) and the US Securities and Exchange Commission (SEC) Office of the Chief Accountant and FASB staff.

Background

2 In May 2008, and in response to the recommendations of the Financial Stability Forum in its report *Enhancing Market and Institutional Resilience* (April 2008), the IASB formed an expert advisory panel.

3 The expert advisory panel comprised measurement experts from preparers and auditors of financial statements, users of financial statements, regulators and others. They met on seven occasions in June – October 2008. The panel identified practices that experts use for measuring and disclosing financial instruments when markets are no longer active. A summary of the panel's discussions were set out in *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. That report is available on the IASB Website.

4 On 30 September the SEC Office of the Chief Accountant and FASB staff issued a press release (Release 2008-234) clarifying fair value accounting. The press release is available on the FASB's Website (www.fasb.org) and the SEC's Website (www.sec.gov).

5 On 10 October, the FASB issued FASB Staff Position (FSP) FAS 157-3, which amended FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) to add an illustrative example of the existing principles in SFAS 157. FSP FAS 157-3 was issued in response to concerns expressed by some that SFAS 157 does not provide sufficient guidance on how to determine the fair value of a financial asset when the market for that asset is not active. FSP FAS 157-3 is available on the FASB's Website (www.fasb.org).

6 On 2, 3 and 14 October the IASB issued press releases stating that it regards the press release of 30 September and US GAAP guidance on fair value measurement (including SFAS 157 and FSP FAS 157-3) as consistent with IAS 39 *Financial Instruments: Recognition and Measurement*. The IASB press releases also state that the IASB and the FASB will continue to co-operate to ensure that the objective of fair value measurement is consistently applied in inactive markets. This will help ensure comparability across borders. The SEC Office of the Chief Accountant and FASB staff have reviewed the following section, 'Important measurement issues', and consider it to be consistent with the aforementioned SEC and FASB staff clarification and FSP FAS 157-3.

The fair value measurement objective

7 The objective of fair value measurement in IAS 39 is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date. A forced liquidation or distress sale (ie forced transaction) at the measurement date is not an orderly transaction.

8 To meet the objective of a fair value measurement, an entity measures the fair value of financial instruments by considering all relevant market information that is available. When measuring fair value using a valuation technique, an entity maximises the use of relevant observable inputs and minimises the use of unobservable inputs.

Using prices from inactive markets

9 A quoted market price in an active market for an identical asset or liability is most representative of fair value and is required to be used (generally without adjustment). Transaction prices in inactive markets might be inputs when measuring fair value, but may not be determinative.

10 Characteristics of an inactive market include a significant decline in the volume and level of trading activity, the available prices vary significantly over time or among market participants or the prices are not current. However, these factors alone do not necessarily mean that a market is no longer active and determining that a market is not active requires judgement. An active market is one in which transactions are taking place regularly on an arm's length basis. What is 'regularly' is a matter of judgement and depends upon the facts and circumstances of the market for the instrument being measured at fair value.

11 Regardless of the level of activity, transaction prices that do not represent distressed transactions cannot be ignored when measuring fair value using a valuation technique, although they might require significant adjustment based on unobservable data. When a market becomes inactive, it is not appropriate to conclude that all market activity represents forced liquidations or distress sales. However, it is also not appropriate to conclude automatically that any transaction price is determinative of fair value. Determining fair value in a market that has become inactive depends on the facts and circumstances and may require the use of significant judgement. Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make, such as for credit and liquidity.

Forced transactions

12 The objective of a fair value measurement is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date; that is, forced transactions are not orderly transactions. In other words, any transaction determined to be forced does not form part of a fair value measurement and the results of forced transactions are not determinative when measuring fair value.

13 An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Even when a market has

become inactive, it is not appropriate to conclude that all market activity represents forced transactions. However, as noted above, it is also not appropriate to conclude automatically that any transaction price is determinative of fair value. Determining whether a particular transaction is forced requires judgement.

Management's estimates in a fair value measurement

14 When relevant observable market data does not exist, or when observable inputs require significant adjustment based on unobservable inputs, fair values are determined using a valuation technique based primarily on management's internal assumptions about future cash flows and appropriately risk-adjusted discount rates. Regardless of the valuation technique used, that technique should not ignore relevant information and reflects appropriate risk adjustments that market participants would make for credit and liquidity risks.

15 In some cases, using unobservable inputs might be more appropriate than using observable inputs. In other words, an entity uses observable transaction prices to the extent they represent the fair value of the instrument. If they do not represent the fair value of the instrument, and significant adjustments need to be made to the observable transaction prices, it might be more appropriate for the entity to use a valuation technique based on unobservable inputs. For example, even when an observable transaction price is available, an entity might need to make significant adjustments to that transaction price because the observable transaction price is not current. Those adjustments might be necessary to arrive at the price at which an orderly transaction would take place between market participants at the measurement date. When significant adjustments are required to available observable inputs it might be appropriate to utilise an estimate based primarily on unobservable inputs. This is commonly referred to as 'mark-to-model'. The determination of fair value often requires significant judgement.

16 In some cases, multiple inputs from different sources might collectively provide the best evidence of fair value. In these cases, expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value measurement depends on the extent to which they provide information about the fair value of the instrument and are relevant in developing a reasonable estimate of fair value.

Using broker quotes and information from pricing services

17 Broker (or pricing service) quotes might be inputs when measuring fair value, but are not necessarily determinative if an active market does not exist for the instrument. In an active market, a broker quote should reflect market information from actual transactions. However, when markets are not active, brokers may rely more on models with inputs based on information available only to the broker. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.