GLOBAL PUBLIC POLICY COMMITTEE[1]

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Determining Fair Value of Financial Instruments under IFRS in Current Market Conditions

Preface

The objective of this paper is to enhance awareness of the requirements of International Financial Reporting Standards (IFRS) in relation to the determination of fair value of financial assets and financial liabilities and related disclosures in the context of current market conditions. It is similar to the paper issued by the Center for Audit Quality on "Measurement of Fair Value in Illiquid (or Less Liquid) Markets" under US GAAP. A draft of this paper has been shared with the Financial Stability Forum, some board members and staff of the International Accounting Standards Board, Standing Committee No. 1 of the International Organisation of Securities Commissions and the Accounting Task Force of the Basel Committee on Banking Supervision.

Developing and interpreting IFRS is the responsibility of the IASB. This paper sets out the requirements of existing IFRS literature only. It does not amend or interpret IFRS.

Background

In recent months financial market conditions have been characterised by significant volatility compounded by a liquidity crunch. Although the primary market shock arose due to defaults on sub-prime mortgages in the United States, the effect has been felt globally due to widespread use of structured securities and leveraged funding. Entities with exposure to the financial markets through debt, equity, derivative and leveraged finance activities may experience significant price volatility as a result of liquidity, credit or other issues. The immediate consequences of current market conditions are credit losses on direct and indirect investments in sub-prime mortgages and securitised loans. However, there have been more widespread effects as lenders and investors have re-evaluated their willingness to provide funding and this resulting lack of liquidity has contributed to a decline in the fair value of financial instruments. As a consequence all entities, not only those with direct or indirect exposure to sub-prime mortgages, could be affected by current market conditions.

This paper highlights those aspects of existing IFRS accounting literature that are most likely to be relevant when establishing the fair value of financial assets and financial liabilities and related disclosures in the context of current market conditions. If financial assets and financial liabilities are not required or permitted to be measured at fair value under IFRS, disclosures of their fair value is required. Therefore this paper addresses the issues relating to the determination of fair value of all financial

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[1] The Global Public Policy Committee (GPPC) of the six largest international accounting networks comprises representatives of BDO International, Deloitte, Ernst & Young, Grant Thornton International, KPMG and PricewaterhouseCoopers, and focuses on public policy issues for the profession.

instruments for measurement and disclosure purposes, although it is most directly relevant to:

(a) assets directly affected by rising defaults on sub-prime loans (for example, asset-backed securities for which the underlying assets are or include sub-prime mortgages);

(b) markets and assets indirectly affected by the ensuing 'credit crunch' (for example, some commercial paper (CP) and interbank markets where liquidity has fallen away sharply). These secondary effects may impact the fair value of investments that do not contain direct sub-prime exposure. They may also affect the data inputs commonly used in valuation models and raise issues about what data inputs can be considered observable market data for the purposes of determining fair value under IAS 39 *Financial Instruments: Recognition and Measurement (IAS 39)*; and

(c) financial liabilities measured at fair value through profit or loss.

It will also be important for entities to provide adequate disclosure about their exposures to risk, risk management, accounting policies and valuation methodologies in the current market conditions. A summary of some of the relevant disclosures are set out at the end of this paper.

Determining fair value of financial instruments

IAS 39.9 defines fair value as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

IAS 39 contains a hierarchy for the determination of fair value in IAS 39.48A and AG69-AG82. Quoted prices in active markets provide the best evidence of fair value and must be used when available. In the absence of such quoted market prices, an entity uses a valuation technique. 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 chosen valuation technique incorporates all factors that market participants would consider in setting a price, minimising entity-specific inputs and is consistent with accepted economic methodologies for pricing financial instruments (IAS 39.48A).

Entities will generally have determined prior to recent market events whether an active market exists for a financial instrument. Entities will need to continue to evaluate what level of the hierarchy applies and on what basis a change in one level of the valuation hierarchy to another (for example, a change from determining fair value using quoted prices to determining fair value using a valuation technique) is justified.

Active markets

IAS 39.48A states that the best evidence of fair value is a quoted price in an active market. Thus if there is a quoted price for the financial instrument in an active market, the entity must use it.

Under IAS 39.AG71, a financial instrument is regarded as quoted in an active market if 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.

IAS 39.AG69 states that fair value is not the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale as there is a presumption that the entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms.

‘Regularly occurring market transactions’ does not mean that there needs to be a consistent number of market transactions from one period to another. Consequently, a significantly lower than normal volume of transactions does not necessarily provide sufficient evidence that there is not an active market and that the observed transactions are forced transactions or distressed sales. Similarly, a lower than normal volume of transactions does not automatically mean that the transactions that are occurring are motivated other than by normal business considerations. It would not be appropriate to disregard observable prices in an active market even if the market is relatively thinner or illiquid as compared to previous periods.

An imbalance between supply and demand (for example, fewer buyers than sellers, thereby forcing prices down) is not the same as a forced transaction or distressed sale. If transactions are occurring between willing buyers and sellers in a manner that is usual and customary for transactions involving such instruments, then these are not forced transactions or distressed sales. Persuasive evidence is required to establish that an observable transaction is a forced or distressed sale.

Similarly, the absence of transactions for a short period does not automatically mean that a market has ceased to be active. If transactions are occurring frequently enough to obtain reliable pricing information on an ongoing basis, then that market would be considered active. However, IAS 39.AG71 requires that, for an active market to exist, there needs to be readily available prices and regularly occurring transactions on an arm's length basis. Accordingly, if observed transactions are no longer regularly occurring even if prices might be available, or the only observed transactions are forced transaction or distressed sales, then the market would no longer be considered active. What is 'regularly occurring' and 'forced transaction’ or ‘distressed sale' is a matter of judgement in the light of the particular facts and circumstances of each observed transaction.

Some may argue that market pricing is irrational and that entities should instead default to a model-based measurement that is based on the economic ‘fundamentals’ of the financial instrument. However, such an approach would not be consistent with IAS 39, as it would not reflect current market conditions and the price at which market participants would currently transact.

Financial instruments should be assessed separately when determining if there is an active market. The fact that there is no active market in one financial instrument should not be taken to imply that there are no active markets in other similar financial instruments.

No active market
If the market for a financial instrument is not active, then IAS 39 requires use of a valuation technique.

IAS 39.AG75 states that the objective of a valuation technique is to establish what the transaction price (i.e., the amount at which an asset is exchanged or a liability settled) would have been on the measurement date. IAS 39.48A requires the chosen valuation technique to incorporate all factors that market participants would consider in setting a price. When there is evidence of a change in credit spread, liquidity or other perceived risks that a market participant would consider in pricing the instrument, IAS 39.AG78 requires the effects of the change to be considered in determining its fair value.

It follows that determining fair value using a valuation technique requires factoring in current market conditions, including current credit spreads and the relative liquidity of the market. The measurement objective remains the same for a model-based valuation as for a valuation using quoted prices in active markets. Hence a valuation technique must reflect how the market could be expected to price the instrument in the conditions that exist at the measurement date.

In cases where it is judged that there is no longer an active market, any transactions that occur may nevertheless provide persuasive evidence of fair value under current market conditions (for example, of the size of liquidity premiums or credit spreads). In addition, relevant information for determining fair value includes observable market prices for similar instruments (whether or not they are in active markets) in accordance with IAS 39.AG74. If such information exists, it must be incorporated in the entity's valuation technique. In addition, IAS 39.AG76 requires any valuation technique to be calibrated periodically against market transactions in the same instrument or available observable market data for similar instruments.

Even in the absence of market transactions or data against which to calibrate the valuation technique, given the turbulent market conditions and the general repricing of credit risk in the markets, an entity needs to consider carefully whether the assumptions and inputs of its models remain appropriate and consistent with those that market participants would currently use to establish a fair value for the instrument.

The extent to which an entity may place reliance on a value provided by a third party (for example, a broker quote or pricing service) for an instrument that is not quoted in an active market, will depend on how the third party has derived that valuation and whether it is in accordance with the requirements of IAS 39. Factors to consider include:

(a) whether it reflects a price at which the entity could be expected to transact (for example, a market to which the entity has access);
(b) whether and how the valuation incorporates recent market events (for example, does it include ‘stale’ prices);
(c) how frequently the valuation is updated to reflect changing market conditions;
(d) the number of sources from which the valuation is derived (a valuation derived from many quotes or data sources is generally preferable to one based on a small number of observations);
(e) whether it reflects actual transactions or merely indicative prices; and
(f) whether it is consistent with available market information, including any current market transactions in the same or similar instruments.

Entities that have financial liabilities measured at fair value should ensure they include the effect of recent market events − in particular, relevant increases in the instrument's credit spread − when valuing those financial liabilities. This may be relevant for derivative liabilities, financial liabilities classified as held for trading, and financial liabilities to which the fair value option is applied.

Disclosures

As discussed above, recent market events are likely to require a number of additional disclosures. The objective of IFRS 7 *Financial Instruments: Disclosures* (IFRS 7) is to provide users with information that enables them to evaluate the significance of financial instruments for the entity's financial position and performance and the nature and extent of risks arising from financial instruments and how an entity manages those risks. IFRS 7 is therefore likely to be of particular relevance in current market conditions and, given that this is the first period in which this standard will be adopted by many entities, particular care will be required to ensure that the objectives set out in IFRS 7 are met.

Specific disclosure requirements to consider in the context of valuation of financial instruments are:

- IAS 1 *Presentation of Financial Statements* (IAS 1) paragraph 113 – significant accounting judgements;
- IAS 1.116 – key sources of estimation uncertainty;
- IFRS 7.9-10 – the amount of any change in the fair value of a loan and receivable or financial liability designated at fair value through profit or loss attributable to movements in the credit risk of that financial instrument;
- IFRS 7.25 – for each class of financial assets and financial liabilities the fair value as compared to its carrying amount;
- IFRS 7.27 − methods and assumptions used to determine fair value; whether fair values are determined by prices quoted in active markets or are estimated using a valuation technique; and the effect of reasonably possible changes in assumptions where valuation techniques are used that are not supported by observable market data.