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P&A accounting alert

IASB Expert Advisory Panel Publishes Guidance on Fair Value in Market that are no Longer Active

Introduction

On October 31, 2008, an Expert Advisory Panel formed by the IASB published guidance entitled *Measuring and Disclosing the Fair Value of Financial Instruments in Markets that are no Longer Active (the Guidance)*. This is accompanied by an IASB Staff summary entitled *Using Judgement to Measure the Fair Value of Financial Instruments when Markets are no Longer Active (the Summary)*

The Expert Advisory Panel comprised measurement experts from preparers and auditors of financial statements, users of financial statements, regulators and others.

Attached to this Accounting Alert is the copy of the Guidance and the Summary.

About the Guidance

Purpose of the Guidance

The Guidance has been written in the context of current market conditions and in response to a request by the Financial Stability Forum. It is intended to provide useful information and educational guidance for measuring and disclosing fair values for entities applying IFRS. The report provides guidance about the processes used and the judgements made when measuring and disclosing fair value.

Key themes - measurement

In discussing measurement, the main issues relate to the significance of transaction prices in less active markets in estimating fair values. If a market is not 'active', a quoted market price is not necessarily the fair value. However, a transaction price in a market that is no longer active is not ignored.

A very high level summary of some of the main conclusions in the Guidance is set out below.

Key themes - measurement

- 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.
- A **forced liquidation or distress sale** is not an orderly transaction and is not therefore relevant.
- 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.
- When market activity declines significantly, **judgment is required** to determine whether the market remains 'active' in this context.
- Regardless of the level of activity, transaction prices that do not represent distressed transactions **cannot be ignored** when using a valuation technique. Those transaction prices might however require significant adjustment.
- 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.
- 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, the technique should not ignore relevant information and should reflect appropriate risk adjustments that market participants would make for credit and liquidity risks. 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.

The Guidance is considered to be consistent with the documents recently issued by the US Financial Accounting Standards Board (FASB) on 10 October and by the Office of the Chief Accountant of the US Securities and Exchange Commission (SEC) and FASB staff on 30 September that looked at fair value measurements in illiquid markets.

Key themes - disclosures

The Guidance also notes that providing enhanced and detailed disclosures about the fair value of financial instruments helps meet the objective of IFRS 7 *Financial Instruments: Disclosures*. Specific recommendations for enhanced disclosures are summarized below.

Key themes - disclosures

- aggregation of disclosures in a way that reflects how management views fair value measurements
- inclusion of disclosures similar to those in the annual financial statements in any interim financial statements when fair values have moved significantly
- disclosure of the control environment over valuation processes
- an understandable and suitably detailed description of the valuation techniques used
- disclosure within a fair value hierarchy (proposed in the recent Exposure Draft of Proposed amendments to IFRS 7)
- a reconciliation of movements in the fair values of instruments measured using significant unobservable inputs (also proposed in the IFRS 7 ED).

Authoritative status

The Guidance is educational. It has not been approved by the IASB and does not establish new requirements. Nonetheless it can be expected that regulators and other users of financial statements will expect entities and their auditors to pay careful attention to its contents.

Should you have any questions or should you need assistance on matters covered in this Accounting Alert, please contact the P&A engagement partner assigned to your company, or send an email to any of the following partners of the Firm:

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