



## **CESR statement**

# **Fair value measurement and related disclosures of financial instruments in illiquid markets**

**October 2008**

## EXECUTIVE SUMMARY

### Introduction

As a consequence of the recent financial turmoil, liquidity conditions in several markets have deteriorated markedly thereby making it more complex to measure the fair value of financial instruments. There is a risk that reduced market activity and increased difficulties to determine fair value using quoted prices could generate inconsistent application of the requirements regarding measurement at fair value among issuers<sup>1</sup>. Moreover, the complexity of valuation and the uncertainty that surrounds it make it all the more important to ensure that investors receive sufficient information on how instruments are valued.

From the viewpoint of securities regulators, CESR considers that it may provide some useful input on the application of the existing requirements. Such input will have the following objectives:

- a. Assist preparers and auditors in the current market situation when preparing the next financial statements.
- b. Promote disclosures that take the investors perspective into account.
- c. Provide input to IASB on fair value measurement and related disclosures of financial instruments in illiquid markets that might assist the IASB in its current work in response to the request from the Financial Stability Forum.
- d. Form the basis for the requested CESR's contribution to ECOFIN.

CESR acknowledges that the competence of setting, formally interpreting standards and issuing general interpretation of existing standards lies with the IASB/IFRIC. Moreover, in this statement CESR takes no position on possible amendments to the current accounting framework. CESR wants to underline that this statement should not be understood as constituting guidance or recommendations on IFRS. The work conducted by CESR remains under the domain of application of current IFRS, as CESR members' role regarding IFRS is the enforcement of financial information. At the same time, as securities regulators, CESR members must ensure that issuers fulfil all information obligations under the requirements of the Transparency Directive and the Market Abuse Directive. Finally, CESR stresses that this statement is not directly enforceable, but should be viewed as an input to help improving issuers practices regarding measurement and related disclosures of financial instruments in illiquid markets.

This statement allows CESR as an organisation composed of securities regulators and enforcers to stress the importance of appropriate application of measurement and disclosure requirements. Recent market events imply that relevant and comprehensive financial information is needed to strengthen market confidence. Also, to ensure that investors can undertake comparisons between the financial statements of different issuers in order to evaluate their relative financial position, performance and changes in financial position, relevant disclosures about the valuation methods, assumptions used and related uncertainty as well as the judgments made by the management are highly important for investors and other users of financial statements. It is also very important for investors that the disclosed information is of a quality that enables users to understand the significance of the information disclosed in the financial statements.

At the same time, CESR alerts users that the difficult market conditions can impact the

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<sup>1</sup> In this paper "Issuer" means the preparer of the financial statements.



financial statements in many ways and the awareness of the characteristics mentioned in the previous paragraph is necessary in order to be able to assess the financial position and performance of issuers.

### **Public consultation and timetable**

CESR published a consultation paper 10 July 2008 seeking views from markets participants on the issues discussed in the document. CESR has taken the responses received into consideration and publishes now the final CESR statement and a feedback statement where CESR provides its comments to the issues raised by the respondents to the consultation. The consultation period started on 10 July 2008 and ended on 12 September 2008. CESR has received 34 responses that can be viewed on CESR website unless the response has been labelled as confidential.

### **Issues to be covered in the statement**

The paramount principle when measuring financial instruments is that fair value should be based on the best information about prices that would occur in the market. According to IAS 39 the starting point for the measurement of financial instruments is the assessment of whether the financial instrument is traded on an active or a non active market. The distinction between active and non active markets is therefore important in the application of the measurement of financial instruments. Notwithstanding the above, there is no bright line distinguishing an active market from a non active market. The measurement principles are defined in the hierarchy of fair value. The application of those measurement principles varies according to whether the market is active or non active. The measurement of financial instruments on active markets is conducted with the reference to quoted prices. If no active market exists, the measurement is determined by using valuation techniques that incorporate all factors that market participants would consider in setting a price, minimising entity-specific inputs.

Linked to the measurement issue is the issue of disclosures of how the measurement principles have been applied. Disclosures of the gains and losses arising from fair value, the uncertainty attached to the results and the sensitivity of these changes in underlying assumptions are also very important when investors and other users assess the financial performance and position of the issuer. When considering the situation of markets under stress, it is therefore relevant to focus on issues linked to both measurement and to disclosures.

This statement focuses therefore on both measurement and disclosure. The topics that have been addressed are the following:

1. Measurement
  - a) Active and non active markets for fair value measurement
  - b) Selection of inputs to valuation techniques for fair value measurement
2. Leading disclosure practices

### **Measurement**

When applying IAS 39 to instruments traded in relatively illiquid markets issuers will need to apply judgment especially regarding whether to consider if the market is active or not, and, if the market is considered active, the specific choice of the most relevant quote to determine fair value. The amount of discretion by issuers to apply that judgment should be properly documented in a valuation policy which should be disclosed. Such policy should provide consistency across time and across financial instruments.

When a market is considered active, the quoted price in the market should be used as the fair value for the financial instrument as stated in IAS 39.AG72. The statement highlights



different pricing sources that can be available as a price in the market.

If no active market exists, then the issuer should use valuation techniques. As the specification of those techniques may often entail a significant amount of judgment, and hence may be subject to significant sensitivity, management of the issuer should be able to explain the criteria, the assumptions and the inputs to the valuation techniques in order to ensure consistency. Also, this would enable the management to explain the results of changes to the valuation techniques when disclosing the information required to the investors and other users of financial statements. Management should disclose the extent to which fair value is determined by reference to similar instruments or using a proprietary model.

CESR's statement further discusses the inputs to the valuation models, in particular the list of factors in IAS 39.AG82. It also stresses the need to give due consideration to the particular facts and circumstances when using indices –such as e.g. ABX.HE<sup>2</sup>- as inputs.

In order to increase the quality of the estimates of the fair value that results from the use of the valuation technique, IAS 39 requires issuers to calibrate the models against observable data.

#### Leading disclosure practices

Given the complexity of many business situations, the different business rationales for holding financial instruments and the uncertainty around fair values, clear disclosures are necessary for users to understand these aspects and their implications for the fair value measurements included in the financial statements. This emphasises the importance of comprehensive disclosures on how management have applied the valuation principles, the sensitivity of those valuations to changes in key assumptions and the degree of uncertainty around the values.

In relation to fair value of financial instruments in illiquid markets, issuers should consider the extent of their material exposures to financial instruments in illiquid markets held at fair value and, in the light of their specific circumstances and the principles of IFRS 7 and IAS 1, decide how much detail they provide. Considering all this, the CESR statement sets out some disclosures that issuers might consider when material. Moreover, the statement provides an example of how issuers could present a useful summary of their valuation procedures in a tabular form.

Finally, CESR would like to stress that it is important that the information is easily available to users of the financial statements. The amount of the information relating to financial instruments may be so extensive that the due consideration should be given to the location of information. When considering where to present the information it should be remembered that such disclosures required by IFRS are part of the financial statements. In addition, issuers should consider how to link the qualitative and quantitative information in order to ensure the understandability of the financial statements.

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<sup>2</sup> Asset Backed Securities Index – Home Equity (ABX.HE Index)



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## A. Introduction

### Accounting issues arising from the financial turmoil

1. As a consequence of the recent financial turmoil, liquidity conditions in several markets have deteriorated markedly thereby making it more complex to measure the fair value of financial instruments.
2. One of the main issues from an accounting perspective in connection with markets under stress is the assessment and application of the criteria for when an active market becomes non active. The application of the measurement principles for financial instruments in IAS 39 would be affected by the outcome of the assessment if the market is active or non active. As a consequence users are interested in the disclosure of the criteria and assumptions used in practice by issuers. Preparers should now be careful in assessing whether markets of financial instruments affected by the turmoil, are active and enhance disclosures on judgments made by management in determining whether an active market exist.
3. When there is no active market for financial instruments, the companies are required to apply valuation techniques and to use assumptions, which entail an increased use of management's judgement. Under the current market conditions it could be difficult for companies to identify the relevant market inputs for the valuation models. There is therefore a risk that reduced market activity and increased difficulties to determine fair value using quoted prices could generate inconsistent application of the requirements regarding measurement at fair value among issuers. Moreover, the complexity of valuation and the uncertainty that surrounds it make it all the more important to ensure that investors receive sufficient information on how instruments are valued. Analyses conducted by some CESR members' show that there are generally broad disclosures about the methods and assumptions used to determine the fair value of financial instruments at line item level in the balance sheet. Information is much scarcer for categories below this level. In addition, while the description of the methods and assumptions used to determine the fair value of financial instruments may be in compliance with IFRS, the information is often too general to be useful for users.

### CESR reaction

4. CESR members considered the type of input they could provide in the abovementioned context. CESRs mission includes the enforcement of standards of financial information to protect investors and promote market confidence by contributing to the transparency of financial information relevant to investors' decision making process.
5. CESR acknowledges that the competence of setting and formally interpreting standards lies with the IASB/IFRIC. As stated in the explanatory notes to CESR standard No 1, principle 20 and in CESR standard no 2, issuing general interpretation of existing standards is part of the standard setting process conducted by the relevant bodies, such as International Financial Reporting Interpretations Committee (IFRIC).
6. The work conducted by CESR remains under the domain of application of current IFRS, as CESR has the role of enforcing current financial information principles and to seek consistent application of IFRS in EU regulated markets. At the same time, as securities regulators, CESR members must also ensure that issuers fulfil all

information requirements under the Transparency Directive<sup>3</sup> and the Market Abuse Directive<sup>4</sup>. Under the latter Directive, issuers have to disclose information promptly to investors when it becomes available irrespectively of the scheduled publication of financial statements.

7. It is also worthwhile to stress that as IFRS are principles based, there can be no one particular way of dealing with numerous situations which may seem similar but in substance are different. Consistent application of IFRS means consistent with the principles and treatments permitted by the standards.
8. A number of committees and organisations have published or are currently working on the issues that this CESR statement covers. <sup>5</sup> In particular, IASB has set up an Expert Advisory Panel in response to the recommendations made by the Financial Stability Forum. The panel will assist IASB in
  - Reviewing best practices in the area of valuation techniques,
  - Formulating any necessary additional guidance on valuation methods for financial instruments and related disclosures when markets are no longer active

#### Objectives of the CESR statement

9. From the viewpoint of securities regulators, CESR considers that it may provide some useful input on the application of the existing requirements. Such input will have the following objectives:
  - e. Assist preparers and auditors in the current market situation when preparing the next financial statements.
  - f. Promote disclosures that take the investors perspective into account.
  - g. Provide input to IASB on fair value measurement and related disclosures of financial instruments in illiquid markets that might assist the IASB in its current work in response to the request from the Financial Stability Forum.
  - h. Form the basis for the requested CESR's contribution to ECOFIN.

#### Status of the CESR statement

10. IFRS are issued by IASB and interpretations of IFRS are the exclusive prerogative of IFRIC. Therefore, CESR wants to underline that this statement should not be understood as constituting guidance or recommendations on IFRS. The CESR statement highlights the relevant standards applicable to the issues discussed and also underlines some leading practices that CESR members have identified. Therefore, the CESR statement is not directly enforceable, but should be viewed as an input to help improving issuers' practices regarding measurement and related disclosures of financial instruments in illiquid markets.

#### Methodology and next steps

11. Analyses of the disclosures prepared by major listed financial institutions has been carried out by some CESR members at national level, and supplemented with information provided by market participants such as issuers, auditors and users. This latter information concerns only the methodologies on measurement of financial instruments in illiquid markets.

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<sup>3</sup> Transparency Directive, art 2. paragraph 1(k) and art. 24, paragraph 4

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0057:EN:PDF>

<sup>4</sup> Market Abuse Directive art. 6:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0025:EN:PDF>

<sup>5</sup> In order to put the CESR statement into the context of the work that other bodies are currently undertaking, the work carried out by others is briefly described in annex 3 to this statement.



12. CESR will continue to monitor the outcome of the work that is currently being carried out in the IASB on this issue. CESR will also monitor other activities regarding measurement and disclosures linked to fair value accounting for financial instruments in the future and may in this connection consider a more in depth analysis. CESR may also consider analysing the application of additional disclosure requirements other than those about measurement and related disclosures of financial instruments in illiquid markets.
13. The CESR statement has been prepared by CESR Fin which is chaired by M. Fernando Restoy, Executive Board Member of the Spanish CNMV.





## **B. Public consultation**

14. CESR published a consultation paper 10 July 2008 seeking views from markets participants on the issues discussed in the document. CESR has taken the responses received into consideration and publishes now the final CESR statement and a feedback statement where CESR provides its comments to the issues raised by the respondents to the consultation. The consultation period started on 10 July 2008 and ended on 12 September 2008. CESR has received 34 responses that can be viewed on CESR website unless the response has been labelled as confidential.

## C. Issues covered in the statement

15. The paramount principle when measuring financial instruments is that fair value should be based on the best information about prices that would occur in the market. According to IAS 39 the starting point for the measurement of financial instruments is the assessment of whether the financial instrument is traded on an active or a non active market. The measurement principles are defined in the hierarchy of fair value. The application of those measurement principles varies according to whether the market is active or non active. The measurement of financial instruments on active markets is conducted with the reference to quoted prices. If an active market does not exist, the measurement is determined by using valuation techniques that incorporate all factors that market participants would consider in setting a price, minimising entity-specific inputs (IAS 39.48A). The distinction between active and non active markets is therefore important in the application of the measurement of financial instruments. Notwithstanding the above, there is no bright line distinguishing an active market from a non active market.
16. Linked to the measurement issue is the issue of disclosures of how the measurement principles have been applied. The disclosures of the gains and losses arising from fair value measurement, the uncertainty attached to the results and the sensitivity of them to changes in underlying assumptions are also very important when investors and other users assess the financial performance and position of the issuer. When considering the situation of markets under stress, it is therefore relevant to focus on issues linked to both measurement and to disclosures.
17. As IFRSs are principle-based standards, management's judgement is an essential part of the fair value measurement process. For that reason and to foster consistent application over time, CESR would expect issuers to adequately document and disclose the policies, criteria and processes in place to determine significant judgements used in the fair value measurement of financial instruments in illiquid markets, such as whether a market is active, whether a price is adjusted because the original price reflects a forced transaction or the assumptions used as input in a model that are not supported by observable market data. Consistency on application of those policies and criteria is also of paramount importance.
18. This statement focuses therefore on both measurement and disclosure. The topics that have been addressed are the following:
1. Measurement
    - a) Active and non active markets for fair value measurement
    - b) Selection of inputs to valuation techniques for fair value measurement
  2. Leading disclosure practices
1. **Measurement**
19. **An active market and quoted prices are referred to in IAS 39.48A:**  
*“The best evidence of fair value is quoted prices in an active market.”*
- Active markets and quoted prices are also mentioned in 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.*”

Moreover, IAS 39.AG69 comments among other things on forced transactions and states:

*“Fair value is not the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distressed sale.”*

20. When applying IAS 39 to instruments traded in relatively illiquid markets issuers will need to apply judgment, especially regarding whether to consider if the market is active or not, and, if the market is considered active, the specific choice of the most relevant quote to determine fair value. CESR would expect issuers to document properly their amount of discretion to apply that judgment in a valuation policy which should be disclosed (IFRS 7.27, which is quoted in the disclosure section of this document). Such policy should provide consistency across time and across financial instruments. Any valuation decision by issuers should be in line with the declared policy that could nevertheless be revised from time to time in a transparent manner to take into account changes in the issuer’s environment.
21. Given the hierarchy that IAS 39 establishes for the determination of fair value, issuers should use quoted prices unless they can justify that an active market does not exist for this instrument. The assessment by issuers should be based on their view regarding whether existing quoted prices are readily and regularly available, represent actual and regularly occurring arms length transactions and are not contaminated by forced or distressed sales.
22. When determining whether markets are active, the objective of the issuer’s assessment should be to decide whether transactions are frequent enough to provide pricing information. Among other criteria issuers may use standard measures of liquidity in the context of regularity such as bid-ask spreads and number of transactions. However, even if the number of transactions is relatively low compared to other markets or to the past, the market could still be active. If observed transactions are no longer regularly occurring, even if the bid-ask prices might be available, the market should not be considered as active anymore. However, those bid-ask prices might continue being relevant to determine fair value.
23. According to IAS 39.AG72 the hierarchy for determining fair value in active markets is as follows:
  - a) Bid prices for assets held and ask prices for liabilities held should be used.<sup>6</sup>
  - b) When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction.
  - c) If conditions have changed since the time of the transaction, the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate.

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<sup>6</sup> IAS 39.AG72 also states that “When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate”.

- d) If the entity can demonstrate that the last transaction price is not fair value (e.g. because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price should be adjusted.
24. When a market is considered active, the quoted price in the market should be used as the fair value for the financial instrument as stated in IAS 39.AG72, irrespective of the size of the holdings of instruments for which an active market exists<sup>7</sup>. In practice different pricing sources can be available as a price in the market, such as actual transactions, binding quotes or provider quotes to the extent that these sources reflect actual transactions.
25. These prices are derived by different criteria and sometimes produce different outcomes. Although bid prices reflected in actual transactions are the preferred source, they might not always be available. In general, issuers may have their own hierarchy of sources for each type of financial instrument. In addition a leading practice is to test the reliability of an initially preferred source by checking consistency with other sources.
26. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts, according to IAS 39.AG72.
27. The concept of a distressed or forced sale is rare and in practice difficult to apply, because there is a presumption in the standard that the market quotes can not be ignored. Therefore, market quotes could only be disregarded for this motive if there is sufficient evidence that they do not constitute a reliable reference for transactions between willing parties in business considerations. Normally, this cannot be the case in liquid markets. Even in less liquid markets, a situation of generalised distressed or forced sales would not in itself invalidate observed transaction prices as a measurement of fair value unless there is sufficient evidence that the issuer would be able to get a higher price should it decide to sell the instrument.
28. In order to identify forced sales, a thorough investigation on volumes, the identity of the seller, the reasons to enter into the transaction and other filters could be used. The practice to track the market price against a reliable internal valuation technique may deliver a useful signal when a significant difference occurs. This signal, however, requires additional evidence of a forced sale before concluding that the corresponding price quote is not a measure of fair value. A forced transaction does not represent fair value but the price of a forced transaction may still provide relevant information when determining fair value and therefore should not be entirely ignored as it may provide evidence to factor into a valuation technique.
29. **If the market for a financial instrument is not active, then issuers are required to use a valuation technique.**

**IAS 39.AG75 states the objective of valuation techniques:**

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<sup>7</sup> This is also reflected in the example in IAS 39 Implementation Guidance E 2.2 regarding Fair value measurements on large holdings, which is elaborating on IAS 39.AG71.

*“The objective of 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.”*

IAS 39.48A stipulates the requirements for valuation techniques:

Valuation techniques *“incorporate all factors that market participants would consider in setting a price.”*

IAS 39.AG82 elaborates on inputs to valuation techniques:

*“An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument’s fair value.”*

The factors that affect the fair value of an instrument are, according to IAS 39.AG82, among others, the time value of money, credit risk, foreign exchange prices, commodity prices, equity prices, volatility, prepayment risk and servicing cost.

30. If no active market exists, then the issuer should use valuation techniques. As the specification of those techniques may often entail a significant amount of judgment, and hence may be subject to significant sensitivity, CESR would expect that the management of the issuer is able to explain the criteria, the assumptions and the inputs to the valuation techniques in order to ensure consistency. Also, this would enable the management to explain the results of changes to the valuation techniques when disclosing the information required to the investors and other users of financial statements. Management should disclose the extent to which fair value is determined by reference to similar instruments or using a proprietary model.
31. Even in cases where a market of a specific instrument is not considered active, transactions conducted in that market or in other markets where similar instruments are traded often provide the most relevant information to determine fair value.
32. However, the use of quoted prices of different instruments than the one being measured should be based on a careful analysis on the similarity and differences of the risk characteristics of the quoted and the instrument being measured.
33. In the case of instruments linked to the subprime crisis, the analysis of risks implies checking whether several features of the underlying assets (such as geographical location, rating, vintage etc) are comparable. Even if the fair value cannot be directly derived from such a transaction because of the missing homogeneity, it is possible to derive inputs, e.g. for default rates, prepayment speeds or discount rates, that could be used in valuation techniques.
34. The list of inputs in IAS-39.AG82 is not meant to be exhaustive. There are at least two further risk factors that have proved relevant in valuation techniques: liquidity risk and correlation risk. Liquidity risk is particularly relevant because during the turmoil market participants experienced difficulties when trying to sell the products that were linked to crisis. Correlation risk is relevant in this connection, as a key factor in deriving the cash flow models used to value some of the structured instruments (i.e. higher correlation between the tranches of a Collateralised Debt Obligations (CDO) portfolio means that the senior tranches bear greater risk than they would normally have in the absence of correlation with the junior tranches). Therefore, the correlation assumptions an issuer factors into the cash flow model will affect the measurement of the instrument.

35. Issuers should test and calibrate valuation techniques against observable data before using the techniques to price financial instruments on non active markets, according to IAS 39.AG76. This should become a continuous monitoring process of models' performance leading to adjustments when needed.
36. The disclosure of how the issuer validates the techniques or models it uses seems also relevant. For example, the issuer should consider disclosing how often it calibrates the technique or models to market, back-test, or otherwise validate it.
37. When the issuer factors information into the model that does not relate to exactly the same instrument that it is measuring, it is necessary for management to use judgment. This is especially the case when issuers use indices as inputs to valuation techniques. These indices, though helpful, require considerable judgement. The use of indices in these circumstances should be based on calibrated models linking the index with securities similar to the ones to be valued. For example, in relation to the Asset Backed Securities Index - Home Equity (ABX.HE index), due account should be paid to the shortcomings for valuation purposes of this index:
- The ABX.HE Index represents only US-Subprime mortgage backed securities.
  - The Triple-A rated tranche is divided into sub tranches with different maturities. The ABX.HE uses the lowest Triple-A rated tranche with the longest maturity for valuation. This causes a downward bias into the price for the whole Triple-A rated tranche.
  - The use of the ABX.HE does not permit controlling for the vintages of the loans underlying represented securities. Applying ABX.HE to securities backed by older loans may lead again to a bias in valuation.
38. Therefore, due consideration must be given to the particular facts and circumstances when using indices to price Asset Backed Securities (ABSs) or CDOs.

## **2. Disclosures**

39. The IFRSs are principles-based standards which rely on the experience and judgment of those preparing the financial statements, as well as auditors and users, when applying them to the particular circumstances. Given the complexity of many business situations, the different business rationales for holding financial instruments and the uncertainty around fair values, clear disclosures are necessary for users to understand these aspects and their implications for the fair value measurements included in the financial statements. This emphasises the importance of comprehensive disclosures on how management has applied the valuation principles, the sensitivity of those valuations to changes in key assumptions and the degree of uncertainty around the values.

*IFRS requirements in IAS 1 Presentation of financial statements and IFRS 7 Financial instruments: Disclosures*

40. **IFRS 7.7 states the disclosure principle regarding the significance of disclosures:**  
“An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance”.



IFRS 7.27 states the specified disclosure requirements regarding fair values. According to this paragraph, an issuer shall disclose among other things:

- a. the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates.
- b. whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique (see paragraphs IAS39.AG71-AG79).
- c. whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (ie without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in equity, total equity.

IFRS 7.31 states the disclosure principle about the nature and extent of risks arising from financial instruments:

“An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.”

Regarding classes of financial instruments and level of disclosure, IFRS 7.6 states:

“When this IFRS requires disclosures by class of financial instrument, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the balance sheet.”

The classes of financial instruments and the level of disclosure are further elaborated on in the application guidance to IFRS 7, in IFRS 7.B1-B3.

Also, under the general requirements for the presentation of financial statements, IAS 1.15c<sup>8</sup> requires to provide additional disclosures:

“In virtually all circumstances, a fair presentation is achieved by compliance with applicable IFRSs. A fair presentation also requires an entity:

...

c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.”

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<sup>8</sup> All references to IAS 1 is made to the 2007 version of the standard, as the 2008 version of IAS 1 issued by IASB in September 2007 is not yet endorsed to be used in EU.

Under IAS 1.116 management is required to disclose key sources of estimation uncertainty:

**“An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of their nature; and their carrying amount as at the balance sheet date”**

41. Disclosures regarding financial instruments are found in both *IAS 1 – Presentation of financial statements* and in *IFRS 7 – Financial Instruments: Disclosures*. The requirements in IAS 1 are of more general character, whilst IFRS 7 requires more detailed disclosures.
42. IFRS 7 became effective for accounting periods beginning on or after January 1, 2007. The standard introduced many new disclosure requirements. While the standard has been applied for the first time by most issuers and while the market conditions have created additional challenges, CESR underlines that particular care and diligence in applying the new requirements are needed to ensure that the objectives set out in IFRS 7 are met.
43. In the current market conditions, it may be necessary for an issuer to provide additional disclosures to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (IAS 1.15c).
44. When considering the content of the disclosures, issuers should also consider the qualitative characteristics of relevance and understandability, which make accounting information relevant for decision making. Relevant accounting information is capable of making a difference in a decision. Understandability is the quality of information that enables users to perceive its significance. Recent market events have led to an increased desirability to see such useful disclosures. Information is not considered useful if it is too generic with little indication of issuer-specific application.
45. In addition, issuers should consider which disclosures regarding judgments and estimation uncertainties are required under IAS 1 Presentation of Financial Statements. This standard requires disclosure of the judgements that management has made in applying the entity's accounting policies that have the most significant effect on the amounts recognised in the accounts. For example, management makes judgements in determining whether financial assets are held-to-maturity investments or when determining whether investments are impaired.
46. According to IAS 1.116 management is also required to disclose key assumptions about the future that have a significant risk of causing a material adjustment to the carrying amounts of assets or liabilities in the following year. These estimates present management with their most difficult, subjective or complex judgements. IAS 1 gives examples of areas that may be covered and of the types of disclosures that can be made in order to help users understand these judgements, including quantification of the effect of the uncertainty (IAS 1.120). These types of disclosures are not required on those assets and liabilities measured at fair value based on recently observed market prices (IAS 1. 119).



47. The corresponding requirements to disclose the sensitivities of fair value estimates in case non observable data are used are included in IFRS 7.27c. IFRS 7 requires that for fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the issuer shall state this fact and disclose the effect of those changes.

*Evidence gathered by CESR members*

48. Through the analyses conducted by some CESR members at national level, CESR noted that there are generally broad disclosures about the methods and assumptions used to determine the fair value of financial instruments at line item level in the balance sheet. There is less information for categories below this level such as for financial instruments in illiquid markets like US Subprime, Alt-A Residential Mortgage-Backed Securities (RMBS) and CDO and Collateralised Loan Obligations (CLO). It is therefore not always easy to identify whether these are material for the issuers concerned. In addition, the description of the methods and key assumptions used to determine the fair value of financial instruments is normally too general. For example it is often stated that a discounted cash flow model is used without further disclosure about assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates as IFRS 7 suggests.
49. The comprehensive disclosures on valuation methods e.g. the disclosures on assumptions used by management in measuring fair values and the valuation methods used are important for investors. In addition, some of the most relevant and important disclosure information is whether fair values are determined in whole or in part using a valuation technique based on assumptions that are not supported by observable market data. In this regard, if the use of unobservable input is material, issuers should disclose, in a manner most useful to the issuer's particular facts and circumstances, how those inputs were determined and how the resulting fair values impacted on the financial position and performance of issuers.
50. CESR believes that there is room for improvement in communicating how the current market conditions have affected issuers, although CESR members have identified improvements in the disclosures included in the latest interim financial statements published. Issuers should consider which information users might expect to see disclosed in the current market conditions in order to restore confidence.

*CESR's views on disclosures under the current market conditions*

51. Issuers will have different business models and approaches to risk management and their use of financial instruments will vary. What may be considered as material, appropriate and meaningful to disclose under current market conditions will also vary between issuers.
52. In relation to fair value of financial instruments in illiquid markets, issuers should consider the extent of their material exposures to financial instruments in illiquid markets held at fair value, and, in the light of their specific circumstances and the principles of IFRS 7 and IAS 1, decide how much detail they provide. In current market conditions issuers should consider disclosing, when material, the information shown further in the Annex 1.

53. The information about the use of valuation techniques and in particular the sensitivities of fair value estimates are important when taking into account that fair values estimated by valuation techniques are more subjective than those established from an observable market price, and that users need information to help them assess the extent of this subjectivity. To conclude, the information about estimation uncertainties is an important area of disclosures in connection with the valuation difficulties in the current market conditions. Finding ways to highlight such uncertainty is important to avoid giving management and market participants a false impression of accuracy. Appropriate sensitivity analysis can play an important role in this respect.
54. It is also important to disclose the potential for valuations to change with changes in market circumstances.
55. CESR believes that the disclosures practices produced in the report from the Senior Supervisors Group (SSG)<sup>9</sup> in displaying sensitivity analysis to changes in the assumptions used, especially with regards to exposures to CDOs, CLOs and mortgage backed securities could usefully be followed in order to enhance the quality of disclosures.
56. Additional consideration applies to the grouping of financial instruments into classes. IFRS 7 requires some disclosures based on classes of financial assets and liabilities which differ from the categories in accordance with IAS 39<sup>10</sup>. According to IFRS 7.6, an issuer shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. Moreover, it is important that issuers provide sufficient information to permit reconciliation to the line items presented in the balance sheet.
57. The classes are determined by the management whereby judgement is needed to a large extent. An issuer decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. CESR believes that this aspect of disclosures on financial information is very central in the current market conditions and stresses that the determination by the management should also be affected by the circumstances of an issuer as the standard states.
58. In the case of assets and liabilities held at fair value through profit or loss, it seems particularly relevant for users, to follow the requirements in paragraphs 9(c), 10 (a) and 11(a) of IFRS 7. Those paragraphs require the issuer to disclose the amount of change, during the period and cumulatively, in the fair value of the financial instrument that is attributable to changes in the credit risk of that instrument, and how it is determined. This information will help users better understand the impact on financial statements regarding the credit deterioration of an issuer of a financial instrument.

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<sup>9</sup> Senior Supervisors Group: "Leading-Practice Disclosures for Selected Exposures", 11 April 2008

<sup>10</sup> For the purpose of measuring a financial asset after initial recognition, the IAS 39 classifies financial assets into the following four categories:

- a. financial assets at fair value through profit or loss;
- b. held-to-maturity investments;
- c. loans and receivables; and
- d. available-for-sale financial assets.

59. Also, in order to promote consistency and improve the transparency in the disclosures related to financial instruments in illiquid markets, issuers should consider providing quantitative information and might consider the use of a tabular form for providing such information. The report by the Senior Supervisors Group provides some examples of leading practice disclosures for specific financial instruments. The table in Annex 2 provides an example of how to present some relevant information about valuation techniques for each relevant asset and liability class in a tabular form. The issuers should also consider which kind of information could be useful for investors considering the requirements in IAS 1 and IFRS 7 that would apply to the specific circumstances of the issuer. For example, issuers could consider additional breakdowns following the way the issuer manages the business, as relevant for investors. Finally, whilst CESR considers that a tabular presentation helps to make the information accessible and comprehensible for investors, it does not intend to prescribe any disclosure formats. As noted in the paragraph *status of the statement* of the introductory section, the statement, including Annex 2 should not be interpreted as guidance on how to apply IFRS 7 although it might help to develop leading practices in this area. CESR acknowledges that different issuers have different approaches to business and risk management and should be able to reflect this in their disclosures. If an issuer does not monitor risks using the metrics in Annex 2, it would need to build new systems to capture this data; therefore it might decide to use other suitable ways to report the information required by IFRS 7.
60. It is important that the information is easily available to users of the financial statements. The amount of information relating to financial instruments may be so extensive that due consideration should be given to the location of information. When considering where to present the information it should be remembered that such disclosures required by IFRS and highlighted in this statement are part of the financial statements as required by IFRS7.B6 and should be identified explicitly as being part of the financial statements when they appear outside the financial statements. In addition, issuers should consider how to link the qualitative and quantitative information in order to ensure the understandability of the financial statements.

## Annex 1 – Relevant disclosures regarding financial instruments in illiquid markets in a situation with markets under stress

In the light of the specific circumstances and the principles of IFRS, even if there are only general requirements for some of the disclosures, issuers should consider the following disclosures, when material, in connection with the issues covered in this statement.

According to IFRS, disclosures regarding financial instruments are required in both IAS 1 – Presentation of financial statements and IFRS 7 – Financial Instruments: Disclosures.

According to IAS 1.15c and 103c, issuers are required to disclose additional information when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the issuers' financial position and financial performance.

In addition, according to IFRS 7.1, issuers are required to disclose the significance of financial instruments for the issuers' financial position and performance. Furthermore, IFRS 7.27 requires disclosures on how issuers have determined the fair value of financial instruments.

Specifically in connection with the issues covered by this statement, the issuers should consider the following disclosures:

1. **A market is active or non active:**  
The most relevant criteria and accounting policies that the issuer consistently applies to arrive at the conclusion on whether a financial instrument's market is active or non active (IFRS 7.27b).
2. **Forced transactions or distressed sales**  
The most relevant criteria and policies that the issuer consistently applies to arrive at the conclusion that a transaction price is adjusted because the original price reflects a forced transaction, distressed sale or similar (IAS 39.AG72 and IFRS 7.27b).
3. **Prioritization among several price sources**  
The most relevant criteria and policies the issuer consistently applies to prioritize among several price sources for obtaining a quoted price for fair value measurement purposes within the hierarchy of fair value (IAS 39. AG72 and IFRS 7.27a).
4. **Information regarding assumptions and data used**  
Information, when a valuation technique was applied, in terms of the assumptions and data used, such as those mentioned underneath (paragraph 5.b) or relating to any other factor incorporated by the model (eg correlation or liquidity risk, volatility, etc). For the same reasons issuers should also consider disclosing (IFRS 7.27):
  - a) whether indexes such as ABX.HE were utilised, its purpose and to what extent,
  - b) to what extent, if applicable, correlation or liquidity risks were taken into account

- c) the nature and extent of the model risk, disclosing the impact on the financial instrument's fair value of changing one or more assumption to reasonably possible alternative assumptions.

**5. Determination of fair value for classes of financial instruments**

Whether fair value has been determined for each specific class of financial instruments<sup>11</sup> (IFRS 7.27a-c):

- a) by reference to a price in an active market (IAS 39. AG71-72):
  - i. a current price without any adjustment
  - ii. the most recent price without any adjustment as long as economic circumstances have not changed
  - iii. the most recent price with adjustments as long as economic circumstances have changed
  - iv. the last transaction price, if it is adjusted as the issuer considers it reflects a forced transaction, distressed sale or alike. In that case the issuer should consider the relevance of disclosing the reason that led it to arrive at that conclusion and how and to what extent the price has been adjusted; or
- b) by a valuation technique whereby the market for the instrument is not active (IAS 39.AG74):
  - i. a recent arm's length transaction, with or without adjustment, of the same instrument;
  - ii. current transaction of a similar instrument, and description of the adjustments carried out;
  - iii. discounted cash flow analysis; or
  - iv. description of other valuation technique whose main features and inputs utilised should be described.
  - v. additionally, if any of the techniques i-iv were applied, disclosure, by different subclasses, of information as to whether the variables, input and adjustment factors include: (1) only data supported in whole by prices from observable markets; (2) data supported in part by prices from observable markets (explaining what part of the data are supported from observable markets); or (3) only data not supported by prices from observable markets.

**6. Changes in economic conditions**

The change and the main reasons for it, as well as any material gain or loss recognised on the instrument, if as a result of a change in economic conditions, the method for determining a financial instrument's fair value has changed (eg. because a market that was considered active in the past is now deemed as no active), (IFRS 7.27b).

<sup>11</sup> If different criteria or methods are used within a class, disclosure of separate information by each relevant subclass should be included.



**Annex 2 – Summary of valuation procedures**

FINANCIAL ASSETS HELD FOR TRADING	OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS	FINANCIAL ASSETS AVAILABLE FOR SALE	FINANCIAL LIABILITIES HELD FOR TRADING	FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT AND LOSS	NOTES
I Quoted prices in active markets					
<i>(of which valuation technique in 2006)</i>					<i>Explain reasons for change</i>
II Valuation techniques (Observable inputs)					
<i>(of which quoted prices in active markets in 2006)</i>					<i>Explain reasons for change</i>
<ul style="list-style-type: none"> <li>▪ Quoted prices in non active markets or of similar instruments</li> </ul>					Explain sources
<ul style="list-style-type: none"> <li>▪ Technique A</li> </ul>					Explain technique and sources



- Technique B

Explain  
technique and  
sources

- .....
- 

III Valuation techniques  
(Non observable  
inputs)

*(of which quoted  
prices in active  
markets in 2006)*

- Technique A
  
- Technique B

*Explain  
reasons for  
change*

Explain  
technique and  
sources

Explain  
technique and  
sources

- .....
-

### Annex 3 – Description of work conducted by other organisations

1. This annex describes the work that other committees and organisations are doing regarding the issue covered in this CESR statement.

1. ECOFIN

ECOFIN identified in its October 2007 response to the financial turmoil improved valuation standards, including of illiquid assets, as one of the main areas for action.

With a view to improve the understanding of banks and other financial institutions' exposures to structured products, supervisors should therefore work with the audit and accounting profession to ensure that accounting standards relating to valuation are sufficiently clear and robust, particularly in relation to illiquid assets, and that standard setters deliver clear and consistent guidance on valuation.

In its March 2008 meeting, the European Council, endorsing the interim report by the ECOFIN Council on financial market stability, recalled the importance for policy action to focus on the improvement of valuation standards, in particular for illiquid assets.

2. The 3 level 3 Committees

The following text is included in the work programme 2008 for the joint work of the three level 3 committees, CESR, CEBS and CEIOPS:

“Fair valuation of securities is based either on market value or modeled value. The recent turbulences show the need to perform some research on how valuation is being performed in financial institutions, and the relevance of cross-sector assessment of this issue. The three Committees will join forces to analyse the cross-sector dimension to valuation, from both the prudential and the investor protection perspective.

Proposed deliverable in 2008:

Based on the respective sector work streams under way, the three Committees will analyse any issues with potential cross-sector dimension in the valuation of illiquid instruments. They will where relevant co-ordinate their work with other international bodies in the field.”

As a contribution to the EFC and ECOFIN, CEBS has recently issued a statement covering issues regarding the level of transparency of bank's exposure to structured finance entities and a review of the state of progress in the efforts made to improve the valuation standards. The statement from CEBS would be the basis for its contribution to the ECOFIN.

3. The Financial Stability Forum

The Financial Stability Forum<sup>12</sup> (FSF) has published a report in April 2008 on “Enhancing Market and Institutional Resilience”. The report was prepared on a

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<sup>12</sup> The findings and recommendations in the statement from The Financial Stability Forum (FSF) are the product of an intensive collaborative effort of the main international bodies and national authorities in key financial centres. They draw on a large body of coordinated work, comprising that of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the 11-13 avenue de Friedland - 75008 PARIS - FRANCE - Tel.: 33.(0).1.58.36.43.21 - Fax: 33.(0).1.58.36.43.30  
Web site: [www.cesr.eu](http://www.cesr.eu)



request from the G7 Ministers and Central Bank Governors. The FSF should undertake an analysis of the causes and weaknesses that have produced the turmoil and to set out recommendations for increasing the resilience of markets and institutions going forward.

The report from FSF contains recommendations and proposals to various organisations in order to enhance the market resilience. The FSF has proposed concrete actions in five different areas :

- Strengthened prudential oversight of capital, liquidity and risk management
- Enhancing transparency and valuation
- Changes in the role and uses of credit ratings
- Strengthening the authorities' responsiveness to risks
- Robust arrangements for dealing with stress in the financial system

Regarding the accounting issues, the FSF has advised the IASB to «Improve and converge financial statementing standards for off-balance sheet vehicles and develop guidance on valuations when markets are no longer active... ».

More specifically, the FSF has urged the IASB to

- “Strengthen its standards to achieve better disclosures about valuations methodologies, and the uncertainty associated with valuation.
- In particular, assess disclosures in year-end 2007 annual statements and draw on the views of investors, firms, auditors, supervisors and regulators about the quality of valuation disclosure practices.
- Enhance guidance on valuing financial instrument when markets are no longer active. It will set-up an expert advisory panel in 2008.”

FSF has also considered the area of audit and in that connection has requested “...the International Auditing and Assurance Standards Board (IAASB), national audit standard setters and regulators to, where relevant, enhance guidance for audits of valuations of complex or illiquid financial products”. This work should be done and sound practice reinforced in 2008-2009.

The G7 Finance Ministers and Central Bank Governors expressed at their meeting in April 2008<sup>13</sup> strong support for the recommendations in the statement by FSF. Regarding the accounting issues, the G7 stated the following:

“Firms should fully and promptly disclose their risk exposures, write-downs, and fair value estimates for complex and illiquid instruments. We strongly encourage financial institutions to make robust risk disclosures in their upcoming mid-year reporting consistent with leading disclosure practices as set out in the FSF's statement.”

and

“The International Accounting Standards Board (IASB) and other relevant standard setters should initiate urgent action to improve the accounting and disclosure

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International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centres. Insights have been gained, as well, from private sector market participants.

<sup>13</sup> Press release from the G7 Finance ministers 11 April 2008

standards for off-balance sheet entities and enhance its guidance on fair value accounting, particularly on valuing financial instruments in periods of stress.”

4. Basel Committee

As stated in the FSF statement, the Basel Committee is planning the following in connection with accounting:

- To issue for consultation guidance to enhance the supervisory assessment of bank’s valuation processes and reinforce sound practices in 2008
- To issue by 2009 further guidance to strengthen disclosure requirements under Pillar 3 of Basel II

5. Senior Supervisors Group (SSG)<sup>14</sup>

The Senior Supervisors Group (SSG) has published a report “Leading Practice Disclosures for Selected Exposures” in April 2008. The report is a response to a request from FSF to undertake a review of disclosure practices regarding exposures to certain instruments that the marketplace now considers to be high-risk or to involve more risk than previously thought.

The SSG report from April 2008 concludes that the results of the survey indicate that disclosure practices can be enhanced without necessarily amending existing disclosure requirements, as disclosure requirements allow firms considerable discretion in how they convey information. The SSG analyzed not only financial statements, but also information contained in earnings press releases and accompanying presentation slides posted on the firms’ public websites.

SSG has also published another report regarding “Observations on Risk Management Practices during the Recent Market Turbulence”. This report was published in March 2008. The topics of this report deals with risk management of the financial instruments that are part of the current crisis. In the report it is also highlighted that the analysis was completed prior to the conclusions of the period of market turmoil. The intentions with the report are among other things that the SSG will support the efforts of the Basel Committee with the results from the report to strengthen the efficacy and robustness of the Basel II capital framework.

In the report the SSG concludes the following regarding firms that avoided the problems regarding the market turmoil:

«Firms that avoided such problems demonstrated a comprehensive approach to viewing firm-wide exposures and risk, sharing quantitative and qualitative information more effectively across the firm and engaging in more effective dialogue across the management team. Senior managers in such firms also exercised critical judgment and discipline in how they valued its holdings of complex or potentially illiquid securities both before and after the onset of the market turmoil. They had more adaptive (rather than static) risk measurement processes and systems that could rapidly alter underlying assumptions to reflect current circumstances; management also relied on a wide range of risk measures to gather more information and different perspectives on the same risk exposures and employed more effective stress

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<sup>14</sup> Senior Supervisors Group (SSG) is a group of supervisors from five countries – France, Germany, Switzerland, United Kingdom and United States. The members are the following : Banking Commission (France), Federal Financial Supervisory Authority (Germany), Federal Banking Commission (Switzerland), Financial Services Authority (United Kingdom), and Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, Office of the Comptroller of the Currency, and Securities and Exchange Commission (United States)..

testing with more use of scenario analysis. In addition, management of better performing firms typically enforced more active controls over the consolidated organization's balance sheet, liquidity, and capital, often aligning treasury functions more closely with risk management processes, incorporating information from all businesses into global liquidity planning, including actual and contingent liquidity risk. »

On the other hand, SSG concludes the following regarding firms that faced significant problems as a result of the market turmoil:

«In particular, some firms made strategic decisions to retain large exposures to super-senior tranches of collateralized debt obligations that far exceeded the firms' understanding of the risks inherent in such instruments, and failed to take appropriate steps to control or mitigate those risks. Such firms have taken major losses on these holdings, with substantial implications for their earnings performance and capital positions. ... Another risk management challenge concerned firms' understanding and control over their potential balance sheet growth and liquidity needs. For example, some firms failed to price properly the risk that exposures to certain off-balance-sheet vehicles might need to be funded on the balance sheet precisely when it became difficult or expensive to raise such funds externally».

#### 6. CFA Institute

The CFA Institute<sup>15</sup> (Chartered Financial Analysts), who represents the view of professional investors, has released on 21 April 2008 a report in light of the earnings statements from banks and other financial intermediaries that reflect changes in the market value of financial instruments.

In the report, the CFA Institute says that "fair value 'smoothing' will mask the reality of market conditions and allow companies to hide risk". This statement is based on a survey among the members of CFA Institute regarding fair value requirements for financial institutions. The survey includes 2.000 responses from the professional investors that are members of the CFA Institute.

Also, the CFA Institute expresses the following view:

«We would like to reiterate our strong support of FASB and IASB and their discussion paper endorsing the broad use of fair value measurement for financial instruments. We believe that the widespread use of fair value measurement will ultimately play an important role in improving market discipline and transparency, as well as assist in making more informed risk management decisions. The CFA Institute Centre believes that current chatter about the need to 'roll-back' or revisit fair value is a misguided effort on behalf of preparers that would ultimately result in less transparency and market integrity. Maintaining the current mixed attribute model for stating financial assets and liabilities has enabled more complacent risk management and has contributed to the lack of market discipline identified by regulators. »

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<sup>15</sup> The CFA Institute is the global membership association that administers the Chartered Financial Analyst (CFA) and Certificate in Investment Performance Measurement (CIPM) curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-statementing standards for the investment industry. CFA Institute has more than 94,000 members, who include the world's 81,000 CFA charterholders, in 131 countries and territories, as well as 135 affiliated professional societies in 56 countries and territories.

7. The Global Public Policy Committee

The Global Public Policy Committee<sup>16</sup> issued in December 2007 a document titled “Determining fair value of financial instruments under IFRS’ in current market conditions”.

The objective of the paper from this Committee is to enhance awareness of the requirements of 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. The paper then provides a summary of the relevant disclosures under the current market conditions. The paper highlights that it is important for entities to provide adequate disclosure about their exposures to risk, risk management, accounting policies and valuation methodologies in the current market conditions.

8. IASB

IASB has currently a number of ongoing projects regarding fair value measurement. In addition, IASB has started or is going to start new streams of work in order to comply with the request from FSF.

Discussion paper “Reducing Complexity in Statementing Financial Instruments”

In March 2008 IASB issued a Discussion Paper “Reducing Complexity in Reporting Financial Instruments”. The discussion paper was open for comments until 19 September 2008.

The document is the first stage in a project which aims to replace IAS 39 Financial Instruments: Recognition and Measurement. The discussion paper analyses the main causes of complexity in reporting financial instruments and proposes possible intermediate approaches to address some of them. Those approaches seek to improve and simplify measurement and hedge accounting by amending or replacing the existing requirements. Furthermore the discussion paper sets out the arguments for and against a possible long-term approach that would use one measurement method for all types of financial instruments in the scope of a financial instruments standard.

IASB seeks views on both the possible long-term and intermediate approaches and is interested to hear about possible alternatives on how it should proceed in developing new standards for statementing financial instruments that are principle-based and less complex.

IASB states the following purpose of issuing such a discussion paper:

“The IASB and the FASB have been urged by many constituents to develop new standards of financial reporting for financial instruments that are principle-based and less complex than today’s requirements. Anecdotal evidence suggests that many users of financial statements and other constituents find the requirements in IAS 39 Financial Instruments: Recognition and Measurement and the requirements under US GAAP difficult to understand, apply and interpret.

The many ways of measuring financial instruments is one of the main reasons for today’s complexity. This discussion paper is being published as a basis for future discussion of issues related to measuring financial instruments and hedge accounting. The ultimate objective of both boards is the convergence and

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<sup>16</sup> The Global Public Policy Committee<sup>16</sup> (GPPC) is a Committee of the six largest international accounting networks which comprises of representatives from BDO International, Deloitte, Ernst & Young, Grant Thornton International, KPMG and PricewaterhouseCoopers, and focuses on public policy issues for the audit profession.



improvement of the requirements for measuring financial instruments and hedge accounting requirements.

Subsequent steps in this project are expected ultimately to lead to new standards, but neither the timing nor the content of those standards has been determined. This discussion paper is designed to gather information to assist the IASB in deciding how to proceed.”

#### Project on Fair value measurement

As a part of the current memorandum of understanding between the IASB and FASB, the two standard setting organisations have the issue of Fair Value measurement on the agenda. A discussion paper was issued in November 2006, and the comments received from constituents are currently being analyzed by IASB and FASB. The analysis of the comments received will aid IASB in developing an exposure draft of an IFRS on Fair Value Measurement Guidance. The discussion paper considers whether the requirements on fair value measurements under US GAAP in FAS 157 could be used in IFRS.

At the joint Board meeting between IASB and FASB on 21 April 2008, the two boards had among other issues discussed Fair Value Measurement Guidance. The project on Fair value measurement was rediscussed at the IASB Board meeting in June 2008, where IASB concluded further discussions are needed before issuing an exposure draft.

On request from FSF, IASB has created an Expert Advisory Panel. This panel has the task of identifying valuation and disclosure issues encountered in practice in the current market environment and the work of the Expert Advisory Panel has been included in the project on Fair value measurement. The Expert Advisory Panel has held a number of meetings during the summer 2008 and has in September 2008 published a paper for public consultation that summarises the discussions of the panel. The comments received in the consultation will be discussed in the IASB Expert Advisory Panel in October 2008 and a final document will be published hereafter. The outcome of the work in the Expert Advisory Panel will assist the IASB in deciding whether additional guidance in this regard might be necessary.

During the fourth quarter of 2008 IASB plans to hold round-table discussions with constituents. IASB has mentioned that an exposure draft on Fair value Measurement is expected to be issued in the first half of 2009.

#### Project on Measurement as part of the project on the Conceptual Framework

As part of the comprehensive project on the Conceptual Framework, which is a joint IASB FASB project, but not part of the Memorandum of Understanding between the two boards, one of the phases concerns Measurement.

The objective of this phase, Phase C, Measurement, is to select a set of measurement bases that satisfy the objectives and qualitative characteristics of financial statementing. IASB and FASB agreed to conduct the measurement phase in three milestones:

- Milestone I: Inventory and Define Possible Measurement Bases
- Milestone II: Evaluate Measurement Basis Candidates
- Milestone III: Draw Conceptual Conclusions and Address Practical Issues.

The goal of IASB and FASB is to issue a discussion paper describing their views on the issues identified regarding measurement by the end of 2008.

### Consolidation and derecognition

In addition to the projects regarding fair value mentioned above, IASB has identified two other projects that are considered to be affected by issues linked to the sub prime crisis.

The two projects are the following projects:

- Consolidation – IAS 27 and SIC 12 on Special Purpose Entities
- Derecognition of financial assets

The goal of the project on consolidation is to publish a single IFRS on consolidation to replace IAS 27 Consolidated and Separate Financial Statements and SIC-12 Consolidation – Special Purpose Entities. At the joint IASB FASB Board meeting in April 2008, IASB mentioned that the project has been accelerated and that the models in IAS 27 (control model) and SIC 12 (risk and rewards model) are currently being aligned, with improved disclosure. The original plan was to publish a discussion paper on the issue in the second half of 2008. As a result of the acceleration of the project, IASB plans to publish an exposure draft, instead of a discussion paper, in the fourth quarter of 2008 with the goal of having the single source of guidance on consolidation. The current project plan envisages the issue of a revised standard in the second half of 2009.

Regarding derecognition, IAS 39 *Financial Instruments: Recognition and Measurement* sets out requirements for derecognising financial assets. These requirements are fundamentally different to the requirements for derecognising financial instruments in US GAAP SFAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Furthermore many find the derecognition requirements in IAS 39, which IASB inherited from its predecessor body, the International Accounting Standards Committee (IASC), to be complex.

Originally, the next milestone in this project was to publish a staff statement on derecognition in the first quarter of 2008 in terms of the objective in MoU. As the project has been accelerated, IASB will present an update of the project at the Board meeting in October 2008.

### Disclosures

As part of the project on Consolidation, IASB will review IFRS 7: Financial Instruments: Disclosures to assess the effectiveness of the standard in ensuring that issuers disclose information that reflects their exposure to risk and any potential losses arising from financial instruments with the off balance sheet entities with which they are involved.