

IFRS Briefing Sheet

IASB Expert Advisory Panel final report *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*, and accompanying IASB Staff Summary

November 2008, **Issue 111**

This IFRS Briefing Sheet summarises information and educational guidance about measuring and providing disclosure about the fair value of financial instruments when markets are inactive, provided in the final report of the International Accounting Standards Board's (IASB) Expert Advisory Panel and the accompanying IASB Staff Summary.

On 31 October 2008 the IASB posted to its Website the final report of its Expert Advisory Panel (the Panel), *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* (the Panel Report), together with an IASB Staff Summary, *Using judgement to measure the fair value of financial instruments when markets are no longer active* (the Staff Summary).

Executive Summary

The Panel Report summarises the Panel's discussions at its seven meetings; it identifies practices that experts use for measuring the fair value of financial instruments when markets become inactive, and practices for fair value disclosures in such situations.

The Panel Report and the accompanying Staff Summary are intended to respond to uncertainty about how to measure fair values

when markets are inactive and about what disclosures may be appropriate in such circumstances. The Panel Report addresses issues such as determining whether a market is inactive and using transaction prices and internal models in measuring fair values. Key points of practice highlighted include:

- the use of judgement in determining whether a market is not active
- the use of observed transaction prices in determining fair values, even if they come from an inactive market
- identifying forced transactions
- reflecting appropriate risk adjustments in determining fair values (i.e., the adjustments a market participant would make)
- the use of broker or pricing service quotes as inputs to valuation models.

Although the Panel Report and the accompanying Staff Summary do not establish new requirements for entities applying IFRSs, they do provide useful information and educational guidance on certain issues that entities may face in measuring and disclosing the fair value of financial instruments in inactive markets. The Panel Report contains a number of illustrative examples, derived from practice, of measurement and disclosure that might be helpful for entities that apply IFRSs. These

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examples do not represent the only approaches to measuring and disclosing fair values, nor do they represent mandatory valuation processes or disclosure practices.

Background

In April 2008 the Financial Stability Forum (FSF) issued a report, *Enhancing Market and Institutional Resilience* to the G7 Ministers and Central Bank governors. That report analysed causes and weaknesses that led to the financial market turmoil of late 2007 and set out recommendations for increasing the resilience of markets and institutions in the future, including recommending that the IASB:

- enhance its guidance on valuing financial instruments when markets are no longer active
- strengthen its standards to achieve improved disclosures about valuations of financial instruments, including disclosures about the methodologies and uncertainties associated with such valuations.

Following the recommendations of the FSF, the IASB formed the Panel, comprising users, preparers and auditors of financial statements, as well as regulators and others, to assist the IASB in achieving these objectives.

In addition, the U.S. Securities and Exchange Commission staff and the U.S. Financial Accounting Standards Board recently have issued guidance on similar issues for entities reporting under U.S. generally accepted accounting principles.

The Staff Summary

The IASB Staff Summary accompanying the Panel Report sets out the context for the Panel Report and summarises important measurement issues:

- The objective of fair value measurement is to arrive at the

price at which an orderly transaction would take place between market participants at the measurement date.

- An entity applies judgement in determining whether a market is not active.
- Even in an inactive market, an entity considers transaction prices that do not represent distressed transactions, although they might require significant adjustment based on unobservable data.
- Regardless of the valuation technique used, an entity includes appropriate risk adjustments that market participants would make, such as for credit and liquidity risk.
- A forced liquidation or distress sale (i.e., a forced transaction) is not an orderly transaction and is not determinative of fair value. An entity applies judgement in determining whether a particular transaction is forced.
- When relevant observable market data does not exist, or when observable inputs require significant adjustment based on unobservable inputs, an entity determines fair values using a valuation technique based primarily on management's internal assumptions about future cash flows and appropriately risk-adjusted discount rates. Such a technique reflects appropriate risk adjustments that market participants would make for credit and liquidity risks.
- An entity might use broker or pricing service quotes as inputs when measuring fair value, however, they are not necessarily determinative if an active market does not exist for the instrument. An entity places less reliance on quotes that do not reflect the result of market transactions; an entity also considers the nature of the quote, e.g., whether it is an indicative price or a binding offer, when weighting the available evidence.

The Panel Report

The Panel Report contains two parts, Part 1: *Measurement* and Part 2: *Disclosure*, as well as an Appendix that reproduces existing and proposed guidance about fair value measurement and disclosure.

Part 1: Measurement

The Panel Report reminds readers of the objective of fair value measurement, and includes a discussion of approaches that may not be consistent with the objective of fair value management.

The Panel Report also identifies certain practices that experts use for measuring the fair values of financial instruments in inactive markets:

- To meet the fair value measurement objective, an entity first considers the terms of the financial instrument, including those governing cash flows and credit protection.
- An entity evaluates market information; such information includes, among other things, transaction prices for the same or similar financial instruments. When indices are used to provide input into a valuation model, an entity assesses to what extent the specific index reflects the instrument that is being valued. When prices from brokers or pricing services are used, an entity obtains an understanding of how those prices were determined and whether they are consistent with the fair value measurement objective.
- The fair value of an entity's financial liabilities includes the effect of its own credit risk.
- When using discounted cash flow methodologies, an entity takes into account factors such as timing of, and uncertainty about, the relevant cash flows.
- Calibration of a model is used to test whether the model reflects current market conditions.

- Models and assumptions may have to be changed over time (e.g., to reflect changing market conditions or refinements in techniques).
- When modelling an instrument as a whole is difficult, an entity might measure the underlying components of an instrument.
- Fair values calculated using a model are adjusted for any factors that are not captured by the model and that market participants would consider in determining fair value.

Part 2: Disclosure

The Panel Report reminds readers that the objective of disclosure is to help users of financial statements understand the techniques used and the judgements made in measuring fair value. It discusses factors that would be helpful for an entity to consider

when providing disclosures about financial instruments measured at fair value, including:

- aggregation and granularity of disclosure
- frequency of disclosure
- disclosure of the control environment
- disclosure of valuation techniques
- disclosure of unobservable inputs, including the effect of using reasonably possible alternative unobservable inputs
- disclosure of changes in own credit risk
- disclosure within a fair value hierarchy
- disclosure of a reconciliation of movements in the fair values of instruments measured using significant unobservable inputs.

The last two disclosures are also included in the IASB's Exposure Draft *Improving Disclosures about Financial Instruments (Proposed amendments to IFRS 7: Disclosures)*, which was published on 15 October 2008. See *IFRS Briefing Sheet* Issue 109, which summarises the IASB's Exposure Draft *Improving Disclosures about Financial Instruments – Proposed amendments to IFRS 7*.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

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Publication name: *IFRS Briefing Sheet*

Publication number: Issue 111

Publication date: November 2008