



FEEDBACK STATEMENT

CESR statement

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

October 2008



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INTRODUCTION

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. 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 issuers¹. 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.

2. From the viewpoint of securities regulators, CESR considered that it could provide some useful input on the application of the existing requirements. Such input would 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.

3. To that effect CESR published a Consultation Paper (Ref: CESR/08-437) on 10 July 2008 seeking views from market participants on key issues regarding the fair value measurement and related disclosures of financial instruments. Therefore the draft statement for consultation focused on both measurement and disclosures. The topics addressed were the following:

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

4. The consultation period started on 10 July 2008 and ended on 12 September 2008. After the due analysis of the responses, CESR published its revised views on 3 October 2008 (*CESR Statement on fair value measurement and related disclosures of financial instruments in illiquid markets* –Ref: CESR/08-713b). Now CESR publishes this feedback statement where CESR provides its comments to the issues raised by the respondents to the consultation.

5. CESR acknowledges that the competence of setting, formally interpreting standards and issuing general interpretation of existing standards lies with the IASB/IFRIC. Moreover, in the Statement CESR takes no position on possible amendments to the current accounting framework. CESR wants to underline that the CESR Statement should not be understood as constituting guidance or recommendations on IFRS. The work conducted by CESR remains under the domain of application

¹ In this paper “Issuer” means the preparer of the financial statements.



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 the 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.

6. After the publication of the CESR statement on 3 October 2008 the following has occurred:

- The Securities and Exchange Commission (SEC) in the US published on 30 September 2008 a press release with Clarifications on Fair Value Accounting under US GAAP.
- IASB published on 2 October 2008 a press release where IASB Staff states that they have considered the clarifications on Fair Value Accounting under US GAAP as stated by US SEC as consistent with IAS 39 Financial Instruments: Recognition and Measurement.
- The Financial Accounting Standards Board (FASB) published on 10 October 2008 a FASB Staff Position paper that clarifies the application of FASB Statement No. 157 on Fair Value Measurement in an market that is not active.
- IASB published on 13 October 2008 an amendment to IAS 39 and IFRS 7 Financial Instruments: Disclosures which permits reclassification of some financial instruments. The amendments were endorsed to be used in the European Union on 14 October 2008.
- On 21 October 2008, the three level 3 committees, CESR, CEBS and CEIOPS, published on a joint statement on the latest developments in accounting.
- The European Commission sent on 27 October 2008 a letter to IASB containing comments on further issues of importance related to IAS 39.
- The IASB Expert Advisory Panel has published its final paper on Measuring and Disclosing the fair value of financial instruments in markets that are no longer active on 31 October 2008..

CESR highlights that. EU preparers, auditors and other stakeholders should consider the educational guidance published by the IASB when preparing, auditing, reviewing or enforcing financial statements. This will help to restore confidence and transparency enhanced in financial markets. CESR will monitor the reaction by IASB to the letter sent by the European Commission to IASB. In addition, CESR will also continue to monitor the outcome of the work that is currently being carried out by the IASB and other organisations on these issues. 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.



FEEDBACK ON CESR'S CONSULTATION PAPER ON FAIR VALUE MEASUREMENT AND RELATED DISCLOSURES OF FINANCIAL INSTRUMENTS IN ILLIQUID MARKETS

Responses received

7. CESR received 34 responses that can be viewed on CESR website unless the response has been labelled as confidential.

8. A list of all respondents is attached as annex 1 to this paper. Respondents can be categorised as follows:

- Banking (banking groups and associations of banks): 13
- Auditors (audit firms and associations of auditors): 7
- Accounting experts (EFRAG, government agencies, national standard setters, associations of accountants): 6
- Investors (associations of investors, insurance groups, asset managers): 7
- Others (Indices' provider): 1

General comments

9. Respondents made a number of general comments about the contents and related issues that were set out in the consultation paper. These are set out below, followed by the feedback from CESR.

General agreement with CESR's views in the draft Statement

10. Overall, respondents considered that the Consultation Paper contains helpful suggestions to assist preparers of financial statements to comply more effectively and consistently with the requirements of IFRS in this area, given the recent illiquidity in many financial markets. Generally they agreed with CESR statements in the Consultation Paper although many commentators have raised detailed points as summarised below in this Feedback Statement.

CESR should not issue guidance on IFRS

11. Notwithstanding the general agreement with the points CESR makes in the Consultation Paper, respondents considered that CESR should not issue its own application guidance on the matters discussed in the paper. As CESR acknowledges, the authority for setting standards, interpreting standards and issuing interpretation guidance on these standards lies with the IASB and IFRIC. Some auditors felt that the guidance provided in the Consultation Paper on IAS 1, IAS 39 and IFRS 7 edges on the border of being interpretative.



12. Moreover, some market participants pointed out that the draft CESR Statement would not be consistent with previous policies agreed by CESR. Principle 20 of CESR's Standard number 1 on Financial Information states that “*material controversial accounting issues will be conveyed to the bodies responsible for standard setting or interpretation*” and that “*no general application guidance on IFRSs will be issued by enforcers*”.

There should not be different sets of guidance dealing with the same topics and CESR should provide its input to the IASB

13. Respondents observed that the credit crunch has produced considerable activity by a number of authorities and stakeholders. They were in general concerned by the lack of coordination of this activity, potentially leading to duplication of effort.

14. In particular they pointed out that the IASB's Expert Advisory Panel, formed following the recommendation of the Financial Stability Forum, is developing its own educational guidance covering similar topics. Auditors, accounting experts and many banks consider that the IASB should be the body that first responds to the accounting issues arising as a result of the turmoil. To ensure that the interests of European stakeholders are looked after properly, appropriate European input and advice on a timely basis needs to be provided.

15. For the reasons above, a common observation from those respondents is that CESR should provide its input to the IASB's Expert Advisory Panel discussions based on the contents of the Consultation Paper and thus should not provide separate guidance. This is a common message from those respondents that are also members of the IASB's Expert Advisory Panel². Therefore, according to these respondents, the objective for the CESR statement should be to advise the IASB and the IASB Expert Advisory Panel instead of being aimed at preparers and auditors.

16. However, the concerns raised by the auditors and banks who are members of the IASB's Expert Advisory Panel and also by accounting experts and many responses from the banking sector were not shared by investors. Moreover, CESR's initiative was welcomed as it was pointed out that regulatory bodies clearly have a role in encouraging and enforcing best practice financial reporting and enforce the requirements for it. From the banking side, it was also accepted that CESR has a role in reminding the issuers of securities of their obligations under the Transparency and Market Abuse Directives and acknowledged that Ecofin has directed CESR to conduct work in this area.

CESR's reaction

17. Regarding the comments mentioned in paragraphs 11-12, CESR has clarified the language in the Statement in order to make it clearer that its views should not be understood as constituting guidance or recommendations on IFRS. On the contrary, the Statement simply highlights the relevant standards applicable to the issues discussed and also underlines some leading practices that CESR members have identified.

² The following respondents to the consultation of the CESR statement are also members of the IASB Expert Advisory Panel: BNP Paribas, Deloitte, Deutsche Bank, Ernst & Young, HSBC, KPMG and PricewaterhouseCoopers



18. Therefore, CESR members' view is that the publication of this statement does not contradict its current policy of not issuing general application guidance on IFRS. CESR's initiative should be interpreted in the context of the current financial turmoil and the ECOFIN's request. Moreover, CESR members considered that they needed to publish their views in the consultation paper having regard to their responsibilities under the Transparency and Market Abuse Directives. This initiative might already have had a positive impact on the transparency of the markets, as CESR members have identified improvements in the disclosures included in the latest interim financial statements published.

19. Concerning the comments summarised in paragraphs 13-16, CESR agrees that the views of the securities supervisors of the European Union should be taken into account by the IASB and has therefore expanded the objectives of its Statement to include explicitly input the IASB work as a goal of the paper. Accordingly, CESR submitted its Statement to the IASB's Expert Advisory Panel on the 3 October 2008.

Summary of responses to Question 1 – Distinction between active and non active markets

1. Do you agree with CESR's views above regarding active and non active markets for fair value measurement?

20. Respondents were generally supportive of the issues raised by CESR regarding active and non active markets.

21. Some market participants argue that draft Statement places excessive weight on the distinction between active markets and non-active markets. They believe instead that there is no bright line distinguishing an active from a non-active market. The level of market activity lies on a continuum, with greater judgement being required as market becomes less active. They think that the underlying philosophy that fair values are based on the best information about prices that would occur in the market is common to all financial instrument valuations and remains the paramount principle.

22. CESR agrees with those comments and has clarified the Statement to put more emphasis on the underlying principle that fair value should be based on the best information available in the market.

23. In paragraph 23 of the Consultation Paper CESR indicated some criteria to assess whether transactions are frequent enough to provide pricing information. Some respondents noted that there might be other criteria that preparers should take into account.

24. CESR agrees with those comments although it does not consider it necessary to amend the draft CESR statement as it clearly states that bid-ask spreads and number of transactions are only some of the criteria that issuers may use.

25. Paragraph 25 referred to different pricing sources in active markets such as actual transactions, binding quotes and provider quotes. One respondent questioned the use of provider quotes when such quotes do not reflect actual transactions or when actual transactions cannot be observed.



26. CESR agrees with this observation and has clarified the Statement that the different sources mentioned may be used to the extent that they reflect actual transactions, in line with IAS 39.AG71.

27. Several respondents commented on paragraph 28 of the Consultation Paper regarding forced sales. Some argue that such forced transactions are regarded as very rare and exceptional by many and CESR should not give the impression that forced transactions are occurring more often than rarely, even in the current market situation. CESR agrees and has amended the CESR Statement accordingly.

28. It has also been observed that the CESR Statement should recognise that forced transactions are not evidence of a fair value, but should not be entirely ignored as they may in some cases provide evidence that supports a valuation technique. Others understood that the message CESR is conveying in this paragraph is that an observed transaction price remains valid in a situation of generalised distressed or forced sale and therefore would be inconsistent with IASB guidance.

29. CESR has amended the CESR Statement reflecting those comments, in order to clarify that 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.

30. Paragraph 29 also addressed the issue of forced sales. Some market participants asked CESR to clarify the meaning of this paragraph as it could give the impression that an internal technique should be used in the first place even if there are current market transactions.

31. CESR intention in the Consultation Paper was not to imply that an internal valuation technique should be the way to determine fair value when there are quoted prices in the market fulfilling the conditions in IAS 39.AG 71. CESR therefore underlines that the purpose of using a valuation technique in the context of paragraph 29 of the Consultation Paper would be only to get evidence on whether the transaction in the market is actually a forced sale. In any case, the CESR Statement further notes that additional evidence would be needed before concluding that the corresponding price quote is not a measure of fair value (paragraph 28 of the CESR Statement).

Summary of responses to Question 2 –Inputs to valuation techniques

2. Do you agree with CESR's views above regarding inputs to valuation techniques for illiquid financial instruments?
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32. Paragraphs 30 to 39 of the Consultation Paper discuss the inputs that CESR considers relevant when no active market exists and the fair value of the instrument needs to be estimated using valuation techniques. Respondents in general considered that this commentary is helpful although it was argued that the text should be reviewed to ensure that it does not go beyond or modify the requirements of IFRS and also that CESR should encourage the IASB to cover these issues comprehensively and in a principles-based way.



33. CESR understands that the clarifications included in the introductory section of the Statement about the status of the paper and its objectives address those concerns.

34. In paragraph 31 of the Consultation Paper CESR expressed the view that issuers should document the criteria, the assumptions and the inputs to the valuation techniques. Some respondents noted that accounting standards and their interpretations are not the appropriate place to prescribe documentation requirements.

35. Whilst CESR still holds the view about documentation behind paragraph 31, it wishes to clarify that its intention is not to require disclosures about documentation in the financial statements. Therefore, CESR has modified the language on documentation in paragraph 30 of the Statement to clarify this whilst keeping the principle that the criteria, the assumptions and the inputs to the valuation techniques should be documented.

36. Paragraph 37 of the Consultation Paper referred to validation of valuation techniques. It has been observed that the wording of this paragraph gives the impression that validation or calibration is considered voluntary steps in the valuation process. CESR agrees that validation and calibration are required in any circumstances by IAS 39 and has therefore amended the formulation of this point in paragraph 36 of the Statement.

Summary of responses for Question 3 –Disclosures of financial instruments in illiquid markets

3. Do you agree with CESR's views above regarding disclosures of financial instruments in illiquid markets?

37. Respondents generally concurred with CESR's views although some of them asked CESR to clarify whether this section is adding additional requirements to IFRS 7.

38. As discussed in the introductory section of the CESR's Statement, this paper should not be understood as constituting guidance or recommendations on IFRS. This work remains under the domain of application of current IFRS. Furthermore, CESR underlines that issuers should provide disclosures that meet investors' needs rather than just comply with formulaic requirements. Following this line of thinking, CESR clarifies that the examples provided in the Statement show only one way of interpreting the disclosure requirements of IFRS and that they may not be relevant to all issuers.

39. Paragraph 40 of the Consultation Paper underlines the importance of disclosures in the context described in the introduction of the document. In the following paragraphs, CESR has compiled the relevant IFRS requirements and provided its views. Some respondents have pointed out that this paragraph goes beyond what is required by IFRS 7 as it refers to all financial instruments whereas IFRS 7.27 (c) only requires disclosure of sensitivity of valuations to differing assumptions for financial instruments in inactive markets where a change in assumptions would change fair value significantly.

40. CESR agrees with this comment and clarifies that the Statement only covers fair value measurement and related disclosures of financial instruments in illiquid markets. Therefore, the corresponding paragraph 39 in the Statement and the rest of the document should be understood as applying only to those instruments.

41. Paragraph 53 and Box 1 in the Consultation Paper highlights some relevant disclosures regarding financial instruments in illiquid markets in a situation with markets under stress that issuers in CESRs view should consider including in their financial statements. Some respondents raised the point that Box 1 seems to be adding disclosures at a more detailed level of the basis of fair values and seems to go beyond the requirements in IFRS 7. CESR is of the view that the explanations in Box 1 are only highlighting issues that should be considered under the specific circumstances of markets under stress. CESR is therefore not of the view that Box 1 as such sets out requirements that go beyond the current requirements in IFRS 7. Also, as mentioned CESR has clarified in the Introduction paragraph of the CESR statement that the Statement should not be understood as constituting guidance or recommendations of IFRS.

42. Several respondents raised doubts about the meaning of paragraph 59. CESR has modified the wording in the corresponding paragraph 58 of the Statement in order to clarify that the information on credit deterioration that is deemed useful for users refers to the issuer of the financial instrument (and not to the preparer of the financial statements).

43. In paragraph 60 of the Consultation Paper CESR stated its views in relation to the location of disclosures in the financial statements. One respondent pointed out that IFRS 7 permits disclosures to be given either in the financial statements or incorporated into the financial statements by cross-reference and therefore recommended CESR to emphasise the importance of identifying disclosures explicitly as being part of the audited financial statements when they appear outside the financial statements.

44. CESR agrees with this suggestion and has clarified its language about location in paragraph 60 of the Statement that now stresses that disclosures required by IFRS are part of the financial statements and should be identified explicitly as being part of the financial statements when they appear outside the financial statements.

Summary of responses to Question 4 –Disclosures in tabular format

4. Do you agree that the benefits of the presentation of disclosures regarding financial instruments in illiquid markets in the example in Box 2 outweigh the costs of preparing this information?
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45. Box two of the consultation paper proposed a tabular form of disclosures, as an example of how to present some relevant information about valuation techniques for each relevant asset and liability.

46. Respondents have raised many comments on this issue. Some respondents considered that a tabular approach showing the extent to which financial instruments are fair valued within various levels of the valuation hierarchy is useful. However the table has also given rise to many



doubts. A number of respondents are of the view that the attempt in Box 2 to standardise the content and format of disclosure is inconsistent with the remit of CESR and that such a tabular format would be a retrograde step which would represent a move away from principles based standards. These respondents also mentioned that mandating a detailed tabular format is not an appropriate approach for this disclosure. Some market participants criticised CESR's proposal as it would in effect introduce some of FAS 157's disclosures and it would not be helpful to deviate from the hierarchy in existing IFRS 7 without amending that hierarchy. It was therefore suggested to leave the matter to the IASB.

47. However, the most common objection to the suggested tabular format is that the level of detail proposed may not be relevant to all issuers or provide useful information to all users as companies adopt different business strategies.

48. CESR proposed in the Consultation Paper an example of a tabular presentation because this format helps to make the information accessible and comprehensible for investors. However CESR's intention was not to prescribe any disclosure formats. As noted in paragraph 10 of the Statement (about the status of the paper), the statement, including the abovementioned table 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 the table, 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. CESR decided to move the table to an Appendix in order to make clearer that the proposed presentation is only an example of how disclosures could be provided.

Annex 1 List of Respondents

Respondents to CESR's Consultation Paper on Fair value measurement and related disclosures of financial instruments in illiquid markets (Ref. CESR/08-437)

	Name	Line of business
1.	Nederlandse Vereniging van Banken (NVB)	Banking
2.	Conseil National de la Comptabilite (CNC France)	Accounting
3.	Accounting Standards Committee of Germany (GASB)	Accounting
4.	KBC Group	Banking
5.	London Investment Banking Association (LIBA)	Banking
6.	Markit	Others
7.	Royal Bank of Scotland (RBS)	Banking
8.	Securities Industry and Financial Markets Association (SIFMA)	Investor
9.	CFA Institute	Investor
10.	The Association of Chartered Certified Accountants (ACCA)	Audit
11.	Institutional Money Market Funds Association – IMMFA	Investor
12.	The Association of German Public Sector Banks	Banking
13.	KPMG	Audit
14.	Organismo Italiano di Contabilita (OIC Italy)	Accounting
15.	International Swaps and Derivatives Association (ISDA)	Investor
16.	Financial Reporting Council (FRC)	Accounting
17.	The Institute of Chartered Accountants in England and Wales (ICAEW)	Audit
18.	PricewaterhouseCoopers (PwC)	Audit
19.	British Banker's Association (BBA)	Banking
20.	Deloitte	Audit
21.	Federation des Experts Comptables Europeens (FEE)	Audit
22.	HSBC	Banking
23.	Associazione Banciara Italiana (ABI)	Banking
24.	European Securitisation Forum (ESF)	Investor
25.	BNP Paribas	Banking
26.	Deutsche Bank	Banking
27.	The Chartered Institute of Management Accountants (CIMA)	Accounting
28.	Allied Irish Banks (AIB Group)	Banking
29.	Ernst & Young	Audit
30.	Intesa Sanpaolo	Banking
31.	CEA – Insurers of Europe	Investor
32.	European Banking Federation (EBF)	Banking
33.	The European Financial Reporting Advisory Group (EFRAG)	Accounting
34.	Associação Portuguesa de Fundos de investimento, Pensões e Patrimónios (APFIPP)	Investor