EFRAG

European Financial Reporting Advisory Group

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Dear Mr Wymeersch

**CESR draft Statement *Fair value measurement and related disclosures of financial instruments in illiquid markets***

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the CESR draft Statement *Fair value measurement and related disclosures of financial instruments in illiquid markets*. Please note that, in developing its comment letters, EFRAG usually prepares a draft letter and invites comment on that draft before finalising the letter. However, because of the relatively short comment period given for the draft Statement, that has not been possible in this case. The comments in this letter have therefore not been subject to any public consultation process.

In the draft Statement, CESR discusses a number of issues that have come to its attention in the aftermath of the recent market turmoil, including:

- how to determine for the purposes of IAS 39 whether or not a market is active;
- which if any quoted prices IAS 39 requires to be used to measure instruments traded in relatively illiquid markets;
- the inputs that are relevant when no active market exists and the fair value of a financial instrument “linked to the subprime crisis” needs to be estimated using ‘valuation techniques’;
- the information that needs to be disclosed to enable users to understand the impact of particular transactions, other events and conditions during such times.

EFRAG’s detailed comments are set out in the appendix to this letter, but to summarise:

- We are very pleased that CESR is carrying out work and commenting on the role that financial reporting might have played in the current difficulties and the possible implications for financial reporting of the difficulties encountered. We find the draft Statement thoughtful and useful, and we agree with much of what it says.
- It is our understanding that CESR’s intention in developing the Statement is partly to help preparers and auditors in applying existing IFRS. We would suggest that

CESR re-positions its Statement as input to the IASB, rather than guidance to preparers. Amongst other things, that would help to emphasise that it is the IASB that should be the body that first responds to the accounting issues arising as a result of the current market turmoil.

- Although we agree with much that the draft Statement says about the distinction between active and non active markets for fair value measurement, we think if real improvement is to be made the starting point should be for the IASB to develop good principle-based requirements and terminology on what is meant by an active market and an inactive market.

- Again, although we broadly agree with what the draft Statement says regarding inputs to valuation techniques for financial instruments in illiquid markets, we believe that what is really needed are clear principles that enable preparers and others to understand clearly what the measurement objective is, what the key terms used are intended to mean, and how issues such as illiquidity etc are to be dealt with when they arise. We think this should be a key objective of the IASB's Fair Value Measurement project.

- CESR is right to emphasise the need for preparers to take great care in developing disclosures that help users to develop a proper understanding of the risks and other uncertainties with which their entity is faced. However, we do not believe that it necessarily follows that more disclosure requirements are needed. Rather, it might be that the existing disclosure requirements can be improved by making them more dynamic (or objective based) and/or that preparers can be helped to understand how to apply the existing requirements more effectively.

- The draft Statement suggests that entities should consider the use of a tabular form for providing quantitative disclosures about, for example, valuation techniques for each relevant asset and liability class. In our view, good, principle-based disclosure requirements should focus on the objective of the disclosure, rather than its form (ie whether it is tabular or not).

If you have any questions about this letter, please do not hesitate to contact either me or Paul Ebling.

Yours faithfully

Stig Enevoldsen
EFRAG Chairman

## Appendix
## EFRAG's detailed comments on CESR's draft Statement

### The intended status of CESR's Statement

1 Over the last year or so, many capital and other financial markets have experienced considerable difficulties. These difficulties, which would appear to be the result of problems that started in the US subprime mortgage sector in 2007, have had a number of consequences, both for companies and for markets. Steps are now being taken to re-establish confidence. With this objective in mind, a number of global, pan-European and European national organisations and bodies have carried out work and commented on the role that financial reporting might have played in these difficulties and the possible implications for financial reporting of the difficulties encountered.

2 EFRAG takes very seriously the questions that are being asked about financial reporting as a result of the current market turmoil. While we do not believe that financial reporting has caused the crisis, we do believe it is essential that a comprehensive review is carried out of existing external financial reporting requirements to determine whether any of those requirements has intensified some or all of the problems that have arisen. It is also essential that any weaknesses identified in the financial reporting requirements are addressed and improvements made as a matter of priority.

3 For those reasons we support CESR's interest in this subject, particularly as it is so well-placed to comment on existing practice.

4 Having said that, it is our understanding that CESR's intentions in developing the Statement are to provide the IASB with CESR's views on the issues that the IASB needs to consider whilst at the same time helping preparers and auditors in applying existing IFRS in a way that enhances the transparency of the information provided and is appropriate in other respects too. We strongly believe that the IASB should be the body that first responds to the accounting issues arising as a result of the current market turmoil and, for that reason, would suggest that CESR re-positions its Statement simply as input to the IASB, rather than guidance to preparers.

5 In a principles-based, high-level financial reporting system there can be a very fine line between standard-setting activity and standards enforcement activity. That line is even finer in this context because of CESR members' responsibility to ensure that preparers fulfil all the information requirements under the Transparency Directive and Market Abuse Directive. Yet EFRAG believes it is a line that is worth preserving in order to ensure that IFRS continues to be a principles-based, high level financial reporting framework.

6 Positioning the CRSR Statement as input to the IASB also seems appropriate bearing in mind that the IASB is itself working on the very same issues that CESR is addressing in its draft Statement.

### Other general comments

7 EFRAG reads the CESR draft Statement to be saying that, although CESR has concluded there is not too much wrong with existing standards, it believes that implementation issues have arisen in practice relating to both measurement and disclosure. Although EFRAG has not carried out a formal investigation of the

matter, CESR's conclusion is consistent with the personal experience of EFRAG's members.

8 We also think the paper's discussion and ideas are insightful and will represent valuable input to the IASB's work.

**Question 1—Do you agree with CESR's views regarding the distinction between active and non active markets for fair value measurement?**

9 Paragraphs 20 – 29 of CESR's draft Statement discuss:

(a) which if any quoted prices IAS 39 requires to be used to measure instruments traded in relatively illiquid markets;

(b) how to determine for the purposes of IAS 39 whether or not a market is active; and

(c) how to determine whether a market quote is based on a forced or distressed sale.

10 We broadly agree with what the draft Statement says on this issue, but have the following additional comments:

(a) We think existing standards are not very clear on what is meant by an active market and an inactive market, and an appropriate clarification of this issue could improve things greatly. We recognise and agree that judgment should play a pivotal role, but to be effective those judgments need to be made within the context of good principle-based requirements and terminology.

(b) We think the criteria identified in paragraph 23 are valid, but the list provided should not be thought of as complete because whether a market is active could be affected by other factors (such as number of contributors etc).

**Question 2: Do you agree with CESR's view above regarding inputs to valuation techniques for financial instruments in illiquid markets?**

11 Paragraphs 30 to 39 of CESR's draft Statement discuss the inputs that CESR considers relevant when no active market exists and the fair value of a financial instrument "linked to the subprime crisis" needs to be estimated using 'valuation techniques'. The discussion in particular notes that:

(a) liquidity risk and correlation risk need to be taken into account;

(b) if an entity is considering using an index, it needs to take great care to ensure that the index is appropriate. "The use of indices...should be based on calibrated models linking the index with securities similar to the ones to be valued." Paragraph 38 then goes on to list some short-comings of the ABX.HE index.

12 Although we again broadly agree with what the draft Statement says, we believe that what is really needed are clear principles that enable preparers and others to understand clearly what the measurement objective is, what the key terms used are intended to mean, and how issues such as illiquidity etc are to be dealt with when they arise. We think this should be a key objective of the IASB's Fair Value Measurement project and we suggest that CESR should, through its statement,

encourage the IASB to cover these issues comprehensively and in a principles-based way in that project and in its other pronouncements on the subject.

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

13 Paragraphs 40 to 61 of CESR's draft Statement discuss disclosure. The discussion in particular:

(a) states that, 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;

(b) notes that information is not useful if it is too generic;

(c) summarises what CESR believes to have been weaknesses in the disclosures provided during the current turmoil; and

(d) makes some suggestions as to how the disclosures being provided could be improved.

14 Although we agree with much of what CESR says regarding the sort of disclosures that are needed about financial instruments for which only illiquid markets exist, we are not convinced that more disclosure requirements are needed. Rather, it might be that the existing disclosure requirements can be improved by making them more dynamic (or objective based). It might also be that CESR's experience, if shared, can help preparers to learn how to apply the existing requirements more effectively. We also believe it important that disclosure requirements that are resulting in information that is not proving useful are identified and eliminated.

**Question 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?**

15 The draft Statement states (in paragraph 60) that, "in order to promote consistency and improve the transparency in the disclosures related to financial instruments in illiquid markets, issuers should consider the use of a tabular form for providing quantitative disclosures. ... The table in Box 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."

16 It seems to us that paragraph 60 is doing two thinks: suggesting that the information set out in Box 2 is relevant information; and suggesting that it would be preferable to disclose such information in tabular form. We are concerned about these proposals.

(a) We think the Box 2 example is in effect suggesting that entities should start providing some of FAS 157's disclosures. The IASB has issued a discussion paper inviting comment on those very disclosures and we think it is premature to be proposing the implementation of the disclosures without taking that consultative process fully into account.

(b) In our view, good, principle-based disclosure requirements should focus on the objective of the disclosure, rather than its form (ie whether it is tabular or not). We think therefore that, rather than talking about providing the disclosure in a tabular form, it would be preferable for CESR's Statement to talk about providing all the information about the valuation techniques for each asset and liability class in a way that makes it easy for users to understand the similarities and difference involved.

**Drafting comments**

17 We think that the draft Statement sometimes uses the terms 'active' and 'liquid' interchangeably. We think they are different notions and the draft would do well to distinguish them more clearly. For example, we think liquidity has a connotation of volume that active does not. For example there may (because of the size of various strategic holdings) be only trading in small amounts of share in a particular company. This could be pretty active, but if someone wanted to trade a larger block they may not be able to, because the market has little liquidity.

18 We think that paragraph 6 of the Annex is oversimplifying things when it describes the CFA Institute as representing "the view of professional investors". There are a number of organisations, including the CFA Institute, that represent the views of professional investors.