

AMF recommendation 2008-13

Fair value measurement of certain financial instruments

Background regulations: Article 223-1 of the AMF General Regulation

The Autorité des Marchés Financiers calls on issuers to refer to the recommendation on fair-value measurement of certain financial instruments of 15 October 2008, which was jointly drawn up by the AMF, the CNC, the Commission bancaire (CB) and the Autorité de Contrôle des Assurances et des Mutuelles (ACAM).¹

Recommendation on fair-value measurement of certain financial instruments

At a summit on 12 October 2008, the heads of the euro area countries set forth the terms of a joint action plan providing, in particular, for a coordinated approach in order to "[ensure] sufficient flexibility in the implementation of accounting rules. [...] Under the current exceptional circumstances, financial and non-financial institutions should be allowed as necessary to value their assets consistently with risk of default assumptions rather than immediate market value which, in illiquid markets may no longer be appropriate".

This declaration follows the recommendation made to supervisors and auditors in the European Union (EU) at the Ecofin Council of 7 October 2008, aimed at avoiding distortion of treatment between US and European banks due to differences in accounting rules as from the interim close on 30 September 2008.

Four French authorities: the national accounting board (Conseil national de la comptabilité), securities regulator (Autorité des marchés financiers), banking supervisor (Commission bancaire) and insurance oversight authority (Autorité de contrôle des assurances et des mutuelles), after meeting with the national institute of statutory auditors (Compagnie nationale des commissaires aux comptes), have issued a joint recommendation to address the accounting treatment of certain financial instruments that can no longer be reliably priced on the market because of the ongoing turmoil.

The aim of the recommendation is to provide clarification for annual and interim periods ending on or after 30 September 2008. It applies to the consolidated financial statements, prepared under prevailing IFRS as adopted by the EU, of entities holding financial assets which are measured at fair value and for which there is no active market.

In the present situation, the market value of certain financial assets is not the only relevant criterion and does not always allow for a proper assessment of companies' financial position and results.

Furthermore, fair value measurement of certain financial instruments, whose changes in value can affect earnings or capital, raises major practical problems for preparers and users of financial statements as well as for statutory auditors.

Accordingly the four authorities have taken note of the joint statement issued on 30 September 2008 by the US Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB), as well as the FASB Staff Position of 10 October (FSP FAS 157-3), which provide

¹ The ACAM, the CB, the Comité des entreprises d'assurance (CEA) and the Comité des établissements de crédit et des entreprises d'investissement (CECEI) merged to become the Autorité de Contrôle Prudentiel in January 2010.

useful clarifications for determining the fair value of a financial asset when the market for that asset is not active. The authorities have also taken note of the statements issued by the International Accounting Standards Board (IASB) on 2 and 14 October 2008, indicating that the SEC and FASB clarifications are consistent with IAS 39 "Financial Instruments: Recognition and Measurement".

The aforementioned clarifications, which have been approved by the four authorities and apply within the framework of IAS 39 in inactive markets, concern the following issues:

- Using the reporting entity's own assumption when relevant market inputs do not exist

In an inactive market, it is justifiable to use the reporting entity's own assumptions for future cash flows and discount rates, appropriately adjusted for the risks that any market participant would take into account (notably counterparty risk, non-performance risk, liquidity risk and model risk). Such adjustments are made in a reasonable and appropriate manner after examining the available information.

- Using broker quotes when assessing available information

Broker quotes are not necessarily representative of fair value in an inactive market if they do not reflect the transactions taking place on that market.

- Taking forced transactions into account when assessing fair value

Transactions resulting from involuntary liquidations or distressed sales must not be taken into account to determine the fair value of a financial instrument.

When markets are illiquid, it is not appropriate to conclude that all market activity represents involuntary liquidations or distressed sales. However, neither is it appropriate to conclude that any transaction price is automatically determinative of fair value.

Determining whether a transaction is an involuntary liquidation or distressed sale requires judgment.

- The role of observable transaction prices in an inactive market

The prices of the few transactions executed in an inactive market are an input to be taken into account when pricing a financial instrument, but they are not necessarily determinative.

In any case, determining whether a market is active or not requires judgment. This can be based on indicators such as a sharp decline in trading volume and the level of activity in the market, a sharp disparity in prices over time and between various market participants, or the fact that prices no longer correspond to sufficiently recent transactions.

Lastly, the four authorities take note that the IASB adopted on 13 October the revised version of IAS 39 with a view to allowing certain financial instruments to be reclassified, in accordance with the recommendations of the 7 October 2008 Ecofin Council meeting.