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Eddy Wymeersch
Chairman
CESR
11-13 avenue de Friedland
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12 September 2008

Re: CESR draft statement *Fair value measurement and related disclosures of financial instruments in illiquid markets*

Dear Mr Wymeersch,

We are pleased to provide you with our observations on CESR draft statement *Fair value measurement and related disclosures of financial instruments in illiquid markets*.

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

In the context of particularly turbulent markets like the current ones, one welcomes efforts to raise awareness about issues relating to financial communications and the application of those accounting standards most affected by such contingent market conditions.

Therefore, in this light, we are in broad agreement with draft consultation document issued by the CESR.

However, with reference to the valuation of financial instruments and in particular the use of prices prevailing in active markets rather than determining values through valuation models, situations of particular tension and volatility such as those of today indicate that some efforts at bringing clarification may be necessary by the IASB (which must remain the sole body responsible for setting accounting standards or their interpretations). In particular, in situations of almost illiquid markets, the use of a market price for valuing many financial instruments becomes more impractical (however, as illustrated in comment 1, some clarification of the concept of an active market is necessary) and the use of valuation techniques in the form of the “comparable approach” or the “mark-to-model approach” becomes especially important. In the application of such techniques, there are many aspects of uncertainty (for example, the measurement of liquidity risk), and greater incisiveness on this issue by the IASB would be much appreciated and would contribute to improving comparability of operators’ financial statements.

Question 1

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

We agree with the considerations made and the references to the provisions of IAS 39 concerning the distinction between active and non-active markets.

However, we would note a part of paragraph 28 that warrants special attention.

If in a “liquid” market it is difficult to identify the existence of “forced” transactions that may affect prices, then in a market with few transactions (or even only one), and above all in a market that has gone from liquid to illiquid, it is possible that some of these few transactions (or even the one transaction) may have taken place for reasons related to resolving issues specific to the entities that engaged in them and, therefore, may not be related to achieving the best possible price.

The final part of the afore-mentioned paragraph 28 seems to suggest that, in the absence of strong indications to the contrary, even in a market with few transactions (and therefore illiquid) the few prices observed are nonetheless a better indication of the fair value compared with that obtained using valuation models.

As IAS 39, and with reference to the current notion of fair value, excludes the use of prices derived from transactions occurring in situations of difficulty, the potential presence among the few transactions of operations occurring under the above-mentioned difficult circumstances could have a significant impact on price formation. Only in the presence of a sufficient number of transactions, of contained bid-ask spreads, of continuity of trading and of reliable contributors is it possible to consider the market prices as being representative of a fair value. In the absence of these elements, market prices may be easily “polluted” by transactions done not “on an arm’s length basis”, and using such prices may lead to inclusion in the valuation of a financial instrument of considerations and expectations particular to those parties involved in the operation, and thus not “market” considerations as in the case of liquid markets. In such circumstances, having to in any case make use of subjective and discretionary valuations, it is more correct to refer to those subjective and discretionary valuations made by the entity that holds and has to value the instrument and, therefore, to the appropriate valuation models. The prices in the market can be used for comparison with the values determined through the valuation models.

However, concerning structured financial products, it is also very complicated to identify individual transactions that are truly comparable because of the peculiar nature of the single products.

Naturally, the use of models and that of the elements considered in defining an active market must form part of a documented policy for fair value determination, defined by structures independent of the operating ones and subject to a formal process of approval within the entity.

Therefore, as the valuation of financial instruments must take place within a logic of a going concern (and not one of liquidation), we believe that the concept should be turned round: in an illiquid market, the use of sporadic prices provided by the market (rather than the use of appropriate valuation models) may be allowed if there is evidence that these transactions are done “on an arm’s length basis” (paragraph AG69 of IAS 39 refers specifically to the going concern concept in the fair value measurement of financial instruments).

Question 2

Do you agree with CESR's views above regarding inputs to valuation techniques for financial instruments?

We agree with the comments on the issues of delicacy pertaining to the use of valuation models and especially the importance of the factors relating to liquidity risk and correlation risk, as also the considerations concerning the use of indices in valuation models. In such circumstances, a careful analysis of the indices is vital for verifying their appropriateness in relation to the instrument to be valued in order to prevent differences in the "credit structure", geographical location, etc. of the underlying asset from leading to erroneous valuations.

Question 3

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

We fully agree with the general considerations set forth in the document concerning disclosures of illiquid financial instruments.

With regard to the disclosures listed in Box 1, it is not clear how to present the prices (or the values if using valuation models) relating to each class of financial instrument (point 5 of Box 1) as clearly each individual instrument within the same class has different values. From a quantitative standpoint, it seems reasonable to indicate for the various homogeneous classes the nominal/notional values, the fair value of the category at the close of the accounting year/period, the fair value of the category at the close of the preceding accounting year/period, and any notes on the reasons for variations.

However, in general, the disclosures relating to the valuation models should be understandable. Excessive technical detail or an overly rigid categorization of the disclosures may lead to information that is lacking in terms of transparency.

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?

Above all in periods of financial market turbulence, such as today, appropriate disclosure of the entity of financial instruments (especially structured products) and of the related economic impacts is unquestionably appropriate even though that may entail some additional burden for entities.

However, in general, given the wide variety of financial products and valuation models (and their evolution over time), it appears difficult to identify a template valid for all products and for all entities. That said, not even the IFRS principles provide for binding disclosure formats. With regard to the table in Box 2, we would note that until now financial operators have presented the measurement of illiquid financial instruments by subdividing them into homogeneous classes (e.g. CDO, ABS, RMBS, etc.) rather than by valuation model applied.

The SSG paper cited in the document envisages a breakdown of values by product. We believe that this form of presentation is more readily understandable than that proposed in the document. The reference to the valuation model can be made in relation to the three general levels provided for determining fair value (quoted prices, comparable approach, and mark-to-model approach). The disclosure should be supplemented with indications of those financial instruments that, compared with the previous accounting period, have changed their level for the purposes of determining fair value.

Yours sincerely,

Angelo Casò
(Chairman OIC)