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Ms Tricia O'Malley
Director of Implementation Activities
International Financial Reporting
Interpretations Committee
30 Cannon Street
London EC4M 6XH

United Kingdom

Düsseldorf, 23 December 2008
466/467

Dear Tricia,

Fair Value Measurement of Financial Instruments in Inactive Markets: Determining the Discount Rate for Present Value Computations (IAS 39)

As we stated at our meeting on 9 December 2008 in London the IDW appreciates the fact that IFRIC was able to arrange a discussion of our submission dated 27 October 2008 at its November Meeting. We understand IFRIC's tentative decision not to add this issue to its agenda but to leave it to the discretion of the Board whether to deal with that issue by means of appropriate application material on fair value measurement.

In addition IFRIC indicated in the published tentative agenda decision that our proposed approach might be inconsistent with both the objective of fair value measurement and the existing guidance in IAS 39. This is because IFRIC had the impression that we were suggesting that within fair value computations particular factors should be adjusted away from a market participant's view.

However, this was never our objective and is not intended. We might note that the discussion of the IDW proposal at the London Roundtable on the global financial crisis also revealed some misunderstandings in this regard. These misunderstandings could be resolved during our discussion on 9 December as follows:

In our submission we quoted IAS 39.AG78, which states that, subsequent to initial recognition, an entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate for use in determining a discount rate for a present value computation. In that case AG78

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
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states that it would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed on initial recognition. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

That means that the drying-up of markets occurring over the last months has to be reflected in adjustments to the liquidity spreads that could be observed when the markets were active for the last time. Thus, for many financial assets the current financial crisis provides obvious evidence (as referred to in IAS 39.AG78) of a change in liquidity risk. The only question is how to arrive at a reliable estimate of this change, given that liquidity spreads are not separately quoted.

In this context we had considered the example given in the FASB Staff Position No. 157.3. Noting that the example left open how the (liquidity) spread that was finally used in determining the discount rate can be justified, we had tried to develop some complementary guidance with regard to that question; specifically, how a reporting entity should deal with a range of possible results consisting of its own estimates and indicative quotes. In our submission, we had presented the idea that a reporting entity should consider the fact that the liquidity risk is usually not infinite, but subject to a maximum. This maximum amount was, in our view, represented by the liquidity risk of a non-tradable loan or receivable which, other than in terms of its tradeability, is comparable with the security to be measured. We learned from the discussion on 9 December, 2008, that it is difficult to justify such an absolute limitation of liquidity risk, because market participants' appetite for liquidity might change. Therefore our proposal should be understood as using the current liquidity risk of a comparable non-tradable loan or receivable as one indicator management could use in applying judgement when determining an appropriate liquidity spread. Thus, the spread has to be adjusted to reflect current market conditions taking into account the current market volatility.

At the end of our submission we had pointed out that, in our view, the reference to "normal" business considerations in IAS 39.AG75 serves firstly to distinguish between "normal" market conditions on the one hand and forced transactions, involuntary liquidations or distress sales on the other, and secondly to eliminate market behaviour that is clearly not indicative of fair value from the valuation. We concede that this wording might be misunderstood as meaning that market prices that are not based on forced transactions, involuntary liquidations or distress sales should be adjusted in order to eliminate effects from the financial crisis on liquidity risk. What we had wanted to convey is that forced transactions, involuntary liquidations or distress sales are not relevant transactions for the purpose of determining fair value and should not form part of a fair value measurement. Therefore, to the extent that their effect can be identified, it would be eliminated. The objective of a fair value measurement model is to replicate an exchange price in the market conditions at the measurement date; if there are no relevant transactions because of market conditions, significant management judgement is required.

We hope that this sufficiently clarifies the meaning of our IFRIC submission.

Yours sincerely

Klaus-Peter Naumann
Chief Executive Officer

Norbert Breker
Technical Director Accounting
and Auditing