

## Techniques for assessment of financial instruments in the Central Bank of Iceland auction of 16 June 2016

In accordance with the Terms of Auction and for the convenience of participants and intermediaries in the Central Bank of Iceland auction for the purchase of Icelandic krónur in exchange for euros, with a transaction date of 16 June 2016, the following is stated in connection with the techniques used by the Central Bank to assess the value of financial instruments, according to the Annual Accounts Act and current financial reporting rules.

Article 13 of the Terms of Auction for the purchase of Icelandic krónur by the Central Bank of Iceland in exchange for euros, with a transaction date of 16 June 2016, states as follows:

*The market value of offshore króna assets shall be based on a reasoned valuation by an impartial chartered accountant of the fair value or cost value of the asset at the time the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions enters into force, as defined according to the Annual Accounts Act, but never lower than the nominal value or book value of the underlying asset. Either the customer or the intermediary shall obtain the valuation at its own expense, and the chartered accountant must provide confirmation of impartiality. The Central Bank of Iceland is authorised to request further explanations or reject the results of the valuation if it is considered demonstrated that the valuation is not based on satisfactory premises.*

The definition of *fair value* according to the Annual Accounts Act, no. 3/2006, can be found in Article 37 of the Act, which reads as follows:

*Statement of financial instruments and liabilities at fair value pursuant to Article 36 shall comply with statutory accounting rules. Such valuation is permitted only if it is based on reliable information on fair value.*

*Fair value shall be determined with reference to:*

- 1. the market price of financial instruments traded in an active market;*
- 2. the market value of underlying factors of the financial instrument in question if the instrument is not listed in the market;*
- 3. a value calculated by means of generally accepted valuation models or techniques for assets which are not traded in the market; such valuation models and techniques shall give a clear value of market value.*

*If these assets or liabilities cannot be assessed at fair value using the above methods, the valuation shall be based on cost price pursuant to Article 29.*

Article 2, Item 13 of the Annual Accounts Act defines *statutory accounting rules* as rules issued by the Accounting Standards Board pursuant to Article 119 of the Act and international accounting standards pursuant to Article 2, Item 12 of the same Act. The international accounting standard IFRS 13 is the standard that explains the calculation of fair value. The standard provides for three valuation techniques:

- 1. The market approach: uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets [IFRS 13:B5]*
- 2. The income approach: converts future amounts (cash flows or income and expenses) to a single current (discounted) amount [IFRS 13:B10]*

3. The *cost approach*: determines the amount that would be required currently to replace the service capacity of an asset (current replacement cost) [IFRS 13:B8]

The selection of inputs to the valuation techniques is not unrestricted. The relevant inputs are based on existing information and assumptions about the asset whose value is being determined. The standard refers to this as the *fair value hierarchy*. [IFRS 13:72]

1. Level 1 inputs are quoted prices in active markets for identical assets. [IFRS 13:76]
2. If no quoted price is available, other observable market-based values (level 2 inputs) shall be used, such as the price of a comparable asset or the price of an identical or comparable asset in an inactive market. It is also possible to use market-based variables other than the quoted price; for instance, yields and implied volatilities. [IFRS 13:81]
3. If neither level 1 or level 2 inputs are available, unobservable inputs (level 3 inputs) must be used [IFRS 13:86]

**In applying Article 13 of the Terms of Auction referred to above, the Central Bank of Iceland will give primary consideration to the techniques and criteria described above in assessing the value of assets. Furthermore, the Central Bank may request the submittal of data used for the valuation presented in connection with participation in the Central Bank auction, on the basis of Article 13 of the Terms of Auction.**