Project **Fair Value Measurement**

Topic **Disclosures about fair value measurements**

147. DSR-Sitzung vom 26.07.2010

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Purpose of this paper

1. This paper addresses the disclosure requirements of a converged fair value measurement standard.

2. This paper asks the boards to:

   (a) decide whether to require entities to provide a sensitivity analysis for fair value measurements classified within Level 3 in the fair value hierarchy, and if so, whether to limit this to financial assets and liabilities (see paragraphs 18-29)

   (b) clarify significant differences in the wording used to describe the disclosures proposed in the IASB's exposure draft *Fair Value Measurement* and required in FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures)[1] (see paragraphs 30-43). These differences include:

      (i) differences in the definition of 'class'

      (ii) disclosure of the effect of changes in credit risk for liabilities

      (iii) disclosure of an entity's policy on transfers between levels of the fair value hierarchy.

[1] Topic 820 codified FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157).

(c) clarify the following issues raised by respondents to the IASB's exposure draft (see paragraphs 44-57):

   (i) proposed amendments to IAS 34 *Interim Financial Reporting* related to interim disclosures about the fair value of financial instruments

   (ii) whether the disclosures apply at initial recognition

   (iii) differences in disclosure requirements for recurring and nonrecurring fair value measurements

   (iv) disclosure by level in the fair value hierarchy for assets and liabilities that are not recognised at fair value on the statement of financial position, but for which their fair values are disclosed in the footnotes.

3. The appendix to this paper summarises the comment letters received about the proposed Level 3 sensitivity analysis disclosure in the FASB's exposure draft of disclosures about fair value measurements, which preceded FASB Accounting Standards Update 2010-06 (Improving Disclosures about Fair Value Measurements).

4. The boards have already had detailed technical discussions on this topic in developing the IASB's exposure draft, SFAS 157 and ASU 2010-06, which amended Topic 820. As a result, the meeting will focus on analysing the differences between the documents, the comments received on the IASB's proposals and feedback received about the implementation of Topic 820. This paper does not replicate the analyses already discussed by the boards in developing the IASB's exposure draft and SFAS 157/Topic 820. Board members should contact the staff for the relevant background materials if needed.

Summary of differences between the IASB's exposure draft and Topic 820

5. The fair value measurement disclosure requirements in the IASB's exposure draft and in Topic 820 are similar. The proposed disclosures in the IASB's exposure draft were based on Topic 820 and IFRS 7 *Financial Instruments: Disclosures*.

6. Prior to publication of the IASB's exposure draft on fair value measurement, the IASB amended IFRS 7 in March 2009 to improve disclosures about the fair value measurement of financial instruments. Those amendments included a requirement to disclose fair value information using a three level hierarchy, consistent with that in Topic 820.

7. The FASB issued ASU 2010-06 in January 2010. ASU 2010-06 requires disclosures about fair value measurements in addition to what was in SFAS 157/Topic 820 and improves comparability with IFRS (both what is currently in IFRS 7 and what is proposed in the IASB's exposure draft).

8. The staff believes that the most significant difference between the disclosure requirements in the IASB's exposure draft and in Topic 820 is the proposed requirement in the IASB's exposure draft (and the existing requirement in IFRS 7) to provide a sensitivity analysis for fair value measurements classified within Level 3 in the fair value hierarchy (see paragraph 21 below). Topic 820 does not have a similar requirement, although the FASB proposed a comparable disclosure when developing ASU 2010-06.

9. The staff thinks that the other differences in disclosure requirements between the IASB's exposure draft and Topic 820 relate primarily to differences in the wording used to describe each disclosure requirement. This paper discusses the more significant wording differences. For minor wording differences, the staff proposes to eliminate those differences, to the extent possible, through the drafting process.

10. The following table summarises the disclosures proposed in the IASB's exposure draft and currently required in Topic 820 (including ASU 2010-06) and includes the staff's suggestions for addressing the identified differences:

Disclosure	Topic 820	IASB ED	Staff Comment
Information disclosed by *class* of assets and liabilities	✓	✓	See staff analysis beginning in paragraph 30
The fair value of each class of assets and liabilities at the end of each interim and annual reporting period	✓	✓ (interim periods required for financial instruments)	See staff analysis beginning in paragraph 44
The level within the fair value hierarchy into which the fair value measurements are categorised in their entirety	✓	✓	Address minor wording differences during the drafting process
The amount of any significant transfers into and/or out of Levels 1 and 2, and the reasons for those transfers	✓	✓	Address minor wording differences during the drafting process
The methods used and assumptions applied in determining fair value	✓	✓	Address minor wording differences during the drafting process
Any changes in valuation techniques and reason for the change	✓	✓	Address minor wording differences during the drafting process
Level 3 roll-forward: • Total gains or losses for the period • Purchases, sales, issues and settlements disclosed on a gross basis • Transfers into and/or out of Level 3	✓	✓	Address minor wording differences during the drafting process
Amount of gains or losses for the period included in profit or loss related to assets or liabilities still held at the reporting date	✓	✓	Address minor wording differences during the drafting process

Disclosure	**Topic 820**	**IASB ED**	**Staff Comment**
Sensitivity analysis for Level 3 fair value measurements	✗	✓	See staff analysis beginning in paragraph 18
If an entity is required or chooses to disclose the fair values of assets or liabilities not measured at fair value in statement of financial position (eg financial instruments measured at amortised cost and property, plant and equipment measured using the cost model), the entity shall disclose the fair value by level of the hierarchy	✗ (Topic 825 (Financial Instruments)[2] requires similar disclosures, but not by level of the fair value hierarchy)	✓	See staff analysis beginning in paragraph 54
Changes in own credit for liabilities, including the amount of the change and how it was calculated	✗ (for liabilities measured at fair value using the fair value option, Topic 825[3] requires similar disclosure)	✓	See staff analysis beginning in paragraph 3643
If there is a difference between the highest and best use of an asset and its current use (depreciable and non-depreciable assets in an asset group), an entity shall disclose the amount of the difference in value and the reason the situation arose	✗ (Topic 820 does not require recognition or disclosure of this difference)	✓	The boards decided at the February joint meeting to require entities to disclose information about when they use an asset in a way that differs from its highest and best use (and that asset is recognised at fair value based on its highest and best use)
Disclosure shall be in tabular format	✓	✓	Address minor wording differences during the drafting process

[2]Topic 825 codified FASB Statement of Financial Accounting Standards No. 107 *Disclosures about Fair Value of Financial Instruments.*
[3]Topic 825 codified FASB Statement of Financial Accounting Standards No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115.*

Disclosure	Topic 820	IASB ED	Staff Comment
Liabilities measured or disclosed at fair value that include a third-party credit enhancement	✓ (disclose the existence of a third-party credit enhancement)	✗ (IFRS 7 requires a description of credit enhancements)	This difference relates primarily to where the disclosure requirement is located in US GAAP and IFRS. The staff does not plan to address this item in the fair value measurement project
Fair value measurements of investments in certain entities that calculate net asset value (NAV) per share	✓ (nature and risks of the investments and whether the investments are probable of being sold at amounts that differ from NAV)	✗	This disclosure is not applicable for IFRS because the IASB decided not to permit a practical expedient
An entity is encouraged, but not required, to combine fair value disclosures under the fair value measurement standard with fair value information disclosed under other standards	✓	✗	The staff does not plan to address this difference

Overview of comments received on the IASB's exposure draft

11. The invitation to comment in the IASB's exposure draft asked interested parties whether the disclosure requirements proposed in the exposure draft enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

12. Some respondents agree with the proposed disclosures. They think it will provide meaningful information to users about the relative subjectivity of fair value measurements.

13. Some respondents find the disclosure requirements to be onerous and do not believe that the benefits outweigh the cost. This is especially true for the Level 3 disclosures (eg the reconciliation table and the sensitivity analysis) and the requirement to provide financial instrument disclosures for interim periods in addition to annual periods. They think the principle in IAS 34 is clear. They are also concerned about the volume of disclosures and think there is a risk of overwhelming users with information.

14. Some respondents are concerned about the differences between the proposed disclosures in the exposure draft and those required in US GAAP. They suggest the IASB consider the FASB's proposals to improve disclosures about fair value measurements. It is important to note that the IASB published the exposure draft before this project became a joint project with the FASB.

15. Some respondents ask for clarification about whether the proposed disclosure requirements are only for re-measurements or if they also apply at initial recognition. They also think it should distinguish between recurring and non-recurring measurements.

16. Some respondents think disclosures should be addressed in each standard because different information might be needed depending on the asset or liability being measured.

Staff analysis and recommendation

17. This section contains the staff's analysis and recommendations about:

    (a) Level 3 sensitivity analysis (paragraphs 18-29)

    (b) Resolving significant wording differences (paragraphs 30-43)

    (c) Resolving issues raised in the comment letters to the IASB's exposure draft (paragraphs 44-57).

Level 3 sensitivity analysis

18. IFRS 7 requires a sensitivity analysis for Level 3 fair value measurements of financial instruments. The IASB's exposure draft proposes an amendment to IFRS 7 to move the sensitivity analysis disclosure to the final fair value measurement standard. The disclosure would apply to all assets and liabilities measured at fair value (ie it would not be limited to financial instruments). It is worth noting that this disclosure requirement was in the previous IAS 32 *Financial Instruments: Disclosure and Presentation*.[4] Topic 820 does not require a similar disclosure about fair value measurements.

19. IFRSs require sensitivity analyses for some non-fair value measurements. For example, IAS 36 *Property, Plant, and Equipment* requires a sensitivity analysis when the recoverable amount (the higher of value in use or fair value less costs to sell) of a cash-generating unit could be less than the carrying amount if the entity were to measure the recoverable amount using different 'key assumptions' (a key assumption is 'an assumption to which the recoverable amount is most sensitive' (IAS 36.134(d)(i))). In addition, IAS 19 *Employee Benefits* requires a sensitivity analysis of medical cost trend rates (IAS 19.120A(o).

20. US GAAP also requires a sensitivity analysis for some non-fair value measurements:

[4] This requirement was added to IAS 32 as part of the 2003 Improvements Project.

(a) FASB Accounting Standards Codification Topic 715 (Compensation—Retirement Benefits)[5] requires an entity to disclose the effect of a 1% increase and decrease in the assumed health care cost trend rates (paragraph 715-20-50-1(m)).

(b) FASB Accounting Standards Codification Topic 860 (Transfers and Servicing)[6] requires an entity to disclose for a transferor's interest in transferred financial assets a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption …independently from any change in another key assumption (paragraph 860-20-50-4(c)(d)).

(c) FASB Accounting Standards Codification Topic 946 (Financial Services—Investment Companies)[7] requires two sensitivity analysis disclosures related to stable value funds (paragraph 946-210-5014(h)):

    (i) the weighted average interest crediting rate under two or more scenarios where there is an immediate hypothetical increase or decrease in market yields, with no change to the duration of the underlying investment portfolio and no contributions or withdrawals

    (ii) using the same scenarios in the first analysis, combined with an immediate, one-time, hypothetical 10 percent decrease in the net assets of the fund due to participant transfers, with no change to the duration of the portfolio.

21. The proposed disclosure requirement in the IASB's exposure draft states:

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[5]Topic 715 codified FASB Statement of Financial Accounting Standards No. 132(R) *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*.
[6]Topic 860 codified FASB Statement of Financial Accounting Standards No. 166 *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*.
[7]Topic 946 codified FSP AAG INV-1 and SOP 94-4-1—Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans.

> 57 ….At a minimum, an entity shall disclose the following information for each class of assets and liabilities:
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> (g) for fair value measurements categorised within Level 3 of the fair value hierarchy, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes. An entity shall disclose how it calculated those changes. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.

22. The FASB proposed a similar disclosure requirement in the exposure draft prior to issuing ASU 2010-06. However, almost all respondents to the exposure draft disagreed with the proposed disclosure stating that the disclosure would not provide useful information and would be costly and operationally challenging. However, user respondents were supportive of the proposed disclosure. The appendix to this paper provides a summary of comments received on this issue in the FASB's exposure draft.

23. During its redeliberations, the FASB decided to defer consideration of a sensitivity analysis disclosure requirement to the joint fair value measurement project. This paper addresses that issue.

24. The FASB's proposed sensitivity analysis disclosure was similar to the requirement in IFRS 7 and in the IASB's exposure draft. However, the FASB's sensitivity analysis disclosure proposal would have specifically required that entities consider the correlation between inputs when performing the sensitivity analysis. IFRS 7 and the IASB's exposure draft do not explicitly require entities to consider correlation between inputs. Users have indicated that the IFRS 7 disclosure would be more helpful if all entities provided information about correlation between inputs.

Outreach performed

25. The staff has performed informal outreach with several user groups familiar with IFRSs and/or US GAAP regarding the usefulness of the sensitivity analysis disclosure in IFRS 7. Overall, users support this disclosure requirement. Some of the comments received included:

(a) the disclosure is helpful in identifying the degree of subjectivity in Level 3 fair value measurements.

(b) the information in the disclosure is useful as a means of having a discussion with company management regarding its Level 3 fair value measurements.

(c) the qualitative discussion around the sensitivity analysis provides useful information to understanding a company's valuation processes and assumptions.

26. Some have observed diversity in how entities are disclosing the sensitivity analysis. For example, the term 'reasonably possible alternative assumptions' is not defined in IFRSs so companies may interpret it differently, which could impact comparability. They suggest putting additional parameters around the requirement to improve comparability and the quality of information provided.

27. Some acknowledged that although comparability and the quality of information provided is sometimes an issue, they do not want the disclosure to be removed altogether from the requirements without including a suitable alternative. Those users did not describe what a suitable alternative might be.

Staff recommendation

28. The staff recommends that the boards require a sensitivity analysis disclosure for Level 3 fair value measurements consistent with the IASB's exposure draft, with the following modifications:

(a) **Change the term 'reasonably possible alternative assumptions'** – The term 'reasonably possible' is defined in US GAAP as *'the chance of the future event or events occurring is more than remote but less than likely'*. In the context of FASB Accounting Standards Codification Topic 450 (Contingencies),[8] this phrase describes situations that are neither remote nor probable. The staff understands that, in current practice under US GAAP, 'reasonably possible' contingencies include

[8] Topic 450 codified FASB Statement of Financial Accounting Standards No. 5 *Accounting for Contingencies*.

a very wide range which also covers scenarios that are more than remote but less than likely. Respondents to the FASB's proposal stated that the scope of 'reasonably possible alternative assumptions' was too broad. The staff thinks that another term, such as 'alternative assumptions that are reasonable in the circumstances' would be an appropriate way to describe it. IAS 36 uses the term 'a reasonably possible change in a key assumption'. Other suggestions by respondents to the FASB's proposal included terms such as 'more likely than not', 'probable', 'reasonable' or 'likely alternative assumptions'

The staff thinks that the boards should not explicitly define how an entity should determine which 'reasonably possible alternative assumptions' to analyse. Some users have suggested that a more rigid definition, such as considering standard deviation or other statistical measures, would improve comparability (IAS 19 and Topic 715 specify that medical cost trend rates should be moved by a set percentage (1% up or down) when performing the sensitivity analysis). The staff thinks that it would not be possible to develop a definition that would be appropriate in all circumstances (eg the IAS 19 requirement is specific to a particular input for a particular liability). Rather, an entity should consider the facts and circumstances to determine how best to meet the objective of the sensitivity analysis disclosure requirement.

(b) **Specify that the sensitivity analysis disclosure should consider the effect of interdependencies or correlation between significant inputs, where practicable** – The Financial Services Authority[9] recently published a report that discussed the sensitivity disclosure requirement in IFRS 7. Paragraph 3.23 of the report states:[10]

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[9] The Financial Services Authority (FSA) is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000 (UK). The FSA is an independent body that regulates the financial services industry in the UK.

[10] Discussion paper 09/5; Financial Services Authority, *Enhancing financial reporting disclosures by UK credit institutions*, October 2009.

> While disclosure of the effect of changes from reasonably possible alternative assumptions can be made on a combined basis (that is, changing more than one significant input at the same time), we believe that disaggregating the effect of each significant input may yield additional useful information for market participants. *However, it would also be important to disclose interdependencies between inputs and/or across products where relevant.* (emphasis added)

When performing the sensitivity analysis in IAS 36, an entity is to incorporate any consequential effects of that change on the other variables used to measure recoverable amount. On the other hand, when performing the sensitivity analysis in IAS 19 and Topic 715, an entity is to change one of the inputs while holding all other assumptions constant.

Many respondents to the FASB's proposal preceding ASU 2010-06 indicated that incorporating correlation would be operationally challenging and costly. However, a sensitivity analysis without consideration of the correlation between inputs provides less relevant information to users. For these reasons, the staff believes that a sensitivity analysis disclosure should consider the interdependencies between inputs, when it is practicable to do so.

(c) **Limit the scope of the sensitivity disclosure requirement to financial assets and financial liabilities** – This scope limitation would exempt from the Level 3 sensitivity disclosure requirements the fair value measurements of nonfinancial items (eg those related to the impairment of goodwill or fixed assets under US GAAP and the fair value of investment properties using the fair value model in IFRSs). Respondents to the FASB's proposal stated that the evaluation of goodwill impairment requires an entity to estimate the fair values of all the remaining assets and liabilities whether recognised or not. The impairment measurement can be complex and may require the use of multiple valuation techniques for different types of assets. Therefore, these respondents believed that the proposed sensitivity disclosures did not meet the cost/benefit criterion for nonrecurring, nonfinancial fair value measurements. (See below for a discussion about recurring and nonrecurring fair value measurements.) In addition, the users we spoke with during our outreach indicated that their main interest for sensitivity analysis for fair value measurements is financial instruments. The staff is not suggesting the boards address sensitivity disclosures already required for non-fair value measurements in other standards (eg IAS 36 and IAS 19).

(d) **Clarify that the sensitivity analysis disclosure is not a worst-case scenario and it is not forward looking** – The objective of the sensitivity analysis is to help users of financial statements to assess the reasonableness of the inputs used and the ranges of fair values and compare them to the inputs used and ranges of fair values disclosed by other entities. The objective of the sensitivity analysis is not to provide forward looking information and it is not a stress test or a worst case scenario. The staff thinks it is important to clarify that the sensitivity analysis provides information about the variability of the fair value measurement at the measurement date.

29. Some have asked what is meant by 'would change the fair value significantly' when performing the sensitivity analysis. 'Significance' is not defined in the IASB's exposure draft, IFRS 7 or Topic 820. The IASB's exposure draft and Topic 820 state that 'assessing the significance of a particular input to the entire measurement requires judgement, considering factors specific to the asset or liability'. In the proposed disclosures, the IASB's exposure draft states that 'significance shall be judged with respect to profit or loss, and total assets or total liabilities'. As noted above, IAS 36 uses the word 'key assumption' rather than 'significant input' and describes a key assumption as 'an assumption to which the recoverable amount is most sensitive' (IAS 36.134(d)(i)). The staff recommends not adding guidance for assessing the significance of an input or significant changes in fair value.

Question 1
Do you agree with the staff recommendation in paragraph 28, subject to the conditions in paragraphs 28(a)-28(d)? If not, what do you propose and why?

Question 2
Do you agree with the staff recommendation in paragraph 29? If not, what do you propose and why?

Significant wording differences

Differences in the definition of 'class'

30. The IASB's exposure draft and Topic 820 both require that an entity disclose information about its fair value measurements by 'class' of assets or liabilities. The IASB's exposure draft does not describe 'class'.

31. IFRSs contain the following definitions of 'class':

Definition	**Standards**
Class of assets: A grouping of assets of a similar nature and use in an entity's operations.	IAS 16 *Property, Plant and Equipment* IAS 36 *Impairment of Assets* IAS 38 *Intangible Assets*

Definition	**Standards**
Class of financial instruments: Grouping of financial instruments that is appropriate to the nature of the information disclosed and that takes into account the characteristics of those financial instruments.	IFRS 7 *Financial Instruments: Disclosures*

32. ASU 2010-06 amended Topic 820 to clarify that an entity should provide fair value measurement disclosures for each class of assets and liabilities. Topic 820 describes 'class' as follows:

> For equity and debt securities, class shall be determined on the basis of the nature and risks of the investments in a manner consistent with the guidance in paragraph 320-10-50-1B [see paragraph 33 below] and, if applicable, shall be the same as the guidance on major security type as described in paragraph 942-320-50-2 [see paragraph 34 below] even if the equity securities or debt securities are not within the scope of paragraph 320-10-50-1B. For all other assets and liabilities, judgment is needed to determine the appropriate classes of assets and liabilities for which disclosures about fair value measurements should be provided. Fair value measurement disclosures for each class of assets and liabilities often will require greater disaggregation than the reporting entity's line items in the statement of financial position. A reporting entity shall determine the appropriate classes for those disclosures on the basis of the nature and risks of the assets and liabilities and their classification in the fair value hierarchy (that is, Levels 1, 2, and 3). In determining the appropriate classes for fair value measurement disclosures, the reporting entity shall consider the level of disaggregated information required for specific assets and liabilities under other Topics. For example, under Topic 815, disclosures about derivative instruments are presented separately by type of contract such as interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, and credit contracts. The classification of the asset or liability in the fair value hierarchy also shall affect the level of disaggregation because of the different degrees of uncertainty and subjectivity involved in Level 1, Level 2, and Level 3 measurements. For example, the number of classes may need to be greater for fair value measurements using significant unobservable inputs (that is, Level 3 measurements) to achieve the disclosure objectives because Level 3 measurements have a greater degree of uncertainty and subjectivity.

33. For equity and debt securities measured at fair value, paragraph 320-10-50-1B of FASB Accounting Standards Codification Topic 320 (Investments—Debt and

Equity Securities)[11] provides the following guidance on the appropriate level of disclosure:

> Major security types shall be based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity shall consider all of the following:
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> a. (Shared) activity or business sector
> b. Vintage
> c. Geographic concentration
> d. Credit quality
> e. Economic characteristic

34. For entities within the scope of FASB Accounting Standards Codification Topic 942 (Financial Services—Depository and Lending)[12], paragraph 942-320-50-2 states that the following classes are required at a minimum:

> In complying with these requirements, financial institutions shall include in their disclosure all of the following major security types, though additional types also may be included as appropriate:
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> a. Equity securities
> b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
> c. Debt securities issued by states of the United States and political subdivisions of the states
> d. Debt securities issued by foreign governments
> e. Corporate debt securities
> f. Mortgage-backed securities
> g. Other debt securities.

35. The staff believes that a converged fair value measurement standard should clearly articulate and define the level at which an entity should provide fair value measurement disclosures. The staff thinks that the description of 'class' should be based on the concepts in IFRSs and in Topic 820 and should include the following principles:

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[11] Topic 320 codified portions of FASB Statement of Financial Accounting Standards No. 115 *Accounting for Certain Investments in Debt and Equity Securities.*

[12] Topic 942 codified portions of FASB Statement of Financial Accounting Standards No. 115 *Accounting for Certain Investments in Debt and Equity Securities.*

(a) an entity should determine the appropriate classes of assets and liabilities based on the nature, characteristics and risks of the assets and liabilities and their classification in the fair value hierarchy.

(b) a class of assets and liabilities often will require greater disaggregation than the entity's line items in the statement of financial position

(c) judgment is needed to determine the appropriate classes of assets and liabilities.

Liabilities – changes in own credit

36. Paragraph 10 of IFRS 7 currently requires an entity to disclose information about the change in the fair value of particular financial liabilities due to changes in the *credit risk* of those liabilities. This disclosure applies to financial liabilities measured at fair value under the fair value option in IAS 39. The IASB's exposure draft proposes a similar, but not identical, disclosure about the change in the fair value of a liability due to changes in the *nonperformance risk* of that liability. This disclosure would apply to *all* liabilities measured at fair value after initial recognition (that is, all financial liabilities, whether or not they are measured using the fair value option, and all non-financial liabilities). It also would require disclosure about all changes in nonperformance risk, which for financial liabilities is credit risk. The IASB's exposure draft did not propose amending IFRS 7 related to this disclosure.

37. Topic 820 does not require such a disclosure. However, Topic 825 requires an entity to disclose the estimated amount of gains and losses from fair value changes included in earnings that are attributable to changes in the *instrument-specific credit risk* for financial liabilities for which the entity has elected the fair value option.

38. The staff believes that a disclosure about the change in the fair value of a liability due to a change in the credit risk of that liability is important information, particularly for financial liabilities. However, the staff thinks the disclosure should remain in IFRS 7 and Topic 825 for the following reasons:

(a) the boards have a project to replace their financial instruments standards and one aspect of that project is responding to issues raised about recognizing gains or losses arising from changes in an entity's own credit risk

(b) the guidance about calculating changes in own credit (eg see IFRS 7 paragraph B4) assumes that changes in fair value arising from factors other than changes in credit risk or in interest rates are not significant. Although this assumption might be sufficient for this particular disclosure, this guidance could not form part of a converged fair value measurement standard because such an assumption might not hold, depending upon the market conditions at the measurement date.

(c) changes in the fair value of a non-financial liability measured at fair value after initial recognition due to changes in *credit risk* is not useful information. Changes in fair value due to changes in *nonperformance risk* would provide useful information, but will be difficult to assess (eg at what stage would one determine that increases in the cost to clean up an environmental liability would lead the entity to determine that it will not perform the obligation?).

39. As a result, the staff thinks that such a disclosure should remain in IFRS 7 and Topic 825 pending completion of the financial instruments project.

Policy on transfers between levels of the hierarchy

40. Topic 820 and the IASB's exposure draft both require an entity to disclose the amounts of significant transfers between Levels 1, 2, and 3 and the reasons for those transfers. The IASB's exposure draft and Topic 820 do not specify when the transfers were deemed to have been made. In response to questions from constituents about when the transfers should be recognised, the FASB included a requirement in ASU 2010-06 that an entity disclose its policy for determining when transfers between levels are recognised (although it did not specify when such transfers are deemed to have been made). The IASB has also received similar questions from its constituents about the disclosure in IFRS 7 and proposed in the exposure draft.

41. Paragraph 820-10-50-2(c)(3) of Topic 820 states:

> …A reporting entity shall disclose and consistently follow its policy for determining when transfers between levels are recognized. The policy about the timing of recognizing transfers shall be the same for transfers into the levels as that for transfers out of the levels. Examples of policies for when to recognize the transfers are as follows:
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> i. The actual date of the event or change in circumstances that caused the transfer
> ii. The beginning of the reporting period
> iii. The end of the reporting period.

42. The staff believes that the requirement for an entity to disclose its policy on when it recognises transfers provides useful information to users and should be included in the converged fair value measurement standard.

Staff recommendations

43. In summary, the staff recommends that the boards:

(a) define 'class' based on the concepts in both IFRSs and Topic 820 and should include the following principles:

(i) an entity should determine the appropriate classes of assets and liabilities based on the nature, characteristics and risks of the assets and liabilities and their classification in the fair value hierarchy

(ii) a class of assets and liabilities often will require greater disaggregation than the entity's line items in the statement of financial position

(iii) judgment is needed to determine the appropriate classes of assets and liabilities (paragraphs 30-35).

(b) not require entities to disclose information about the change in *the nonperformance risk of* a *liability* in a converged fair value measurement standard (paragraphs 36-39)

(c) require an entity to disclose its policy for determining when transfers between levels of the fair value hierarchy are recognised (paragraphs 40-42).

Question 3
Do you agree with the staff recommendations in paragraph 43? If not, what do you propose and why?

Clarifications of issues raised by respondents to the IASB's exposure draft

Proposed amendment to IAS 34

44. The IASB's exposure draft proposes an amendment to IAS 34. This amendment would require an entity to provide the fair value measurement disclosures for financial instruments in its interim financial statements. This amendment applies only to financial instruments.

45. Many respondents to the IASB's exposure draft did not comment on the proposed amendment to IAS 34. However, a few respondents did not support the proposed amendment. Some stated that the principles in IAS 34 address when disclosures should be updated. Others said that the costs of providing updated disclosures about fair value measurements outweigh the benefits.

46. The staff thinks the proposal to specify that an entity is required to prepare interim disclosures about the fair value of financial instruments is important given the recent financial crisis.

Disclosures at initial recognition

47. The IASB's exposure draft does not explicitly state whether the fair value measurement disclosures are required at initial recognition or if they are only for subsequent measurement. Topic 820 requires disclosure about fair value measurements only in periods after initial recognition. Some respondents to the IASB's exposure draft requested clarification on this issue and stated that the requirement should be consistent with US GAAP. The staff thinks that a converged fair value measurement standard should clarify that the disclosures about fair value measurements are required only in periods after initial recognition.

Recurring and nonrecurring fair value measurements

48. The disclosure requirements in Topic 820 separately discuss recurring (eg for financial assets held for trading) and nonrecurring (eg for goodwill impairments) fair value measurements.

49. Recurring and nonrecurring are not defined, but for this purpose they mean the following:

    (a) *recurring* fair value measurements: assets and liabilities measured and recognised at fair value on the statement of financial position on a regular basis (eg for each reporting period) after initial recognition. Many financial instruments are measured at fair value on a recurring basis.

(b) *nonrecurring* fair value measurements: assets and liabilities that are recognised at fair value on the statement of financial position after initial recognition only in specific circumstances. In US GAAP examples of nonrecurring fair value measurements are goodwill and other asset impairments. IFRSs do not have any nonrecurring fair value measurements.[13]

50. ASU 2010-06 amended Topic 820 to eliminate most differences between recurring and nonrecurring disclosure requirements. The only differences between them now are:

(a) a reconciliation of activity within Level 3 measurements (commonly referred to as the "Level 3 rollforward")

(b) disclosure of the amounts of significant transfers between Level 1 and 2.

51. Both of these disclosures are required only for recurring fair value measurements.

52. The IASB's exposure draft does not provide separate guidance about disclosures for recurring and nonrecurring fair value measurements because the IASB concluded that the disclosures should be the same for both recurring and nonrecurring fair value measurements.

53. The staff thinks that the same disclosure requirements are appropriate for both recurring and nonrecurring fair value measurements, except for the Level 3 rollforward and transfers between Levels 1 and 2. A converged fair value measurement standard should clarify that those disclosures are required only for recurring fair value measurements.

Disclosure of fair value for items not recognised at fair value

54. Topic 825 and IFRS 7 require the disclosure of the fair value of financial instruments that are not measured at fair value in the statement of financial

[13] The impairment model in IAS 36 uses recoverable amount, which is the higher of fair value less costs to sell and value in use, thus would not be subject to the fair value measurement disclosure requirements (IAS 36 requires disclosures about fair value less costs to sell when that is the recoverable amount).

position. The IASB's exposure draft proposed that for each class of assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed (eg as required in IFRS 7), an entity must disclose the fair value by the level of the fair value hierarchy. For example, an entity would disclose the fair value of a loan asset held at amortised cost along with the fact that it would be classified in Level 1, 2 or 3 of the fair value hierarchy. The other fair value disclosures, such as the Level 3 rollforward, would not be required. Topic 820 does not have a similar disclosure.

55. The respondents to the IASB's exposure draft (and the exposure draft preceding amendments to IFRS 7 in 2008) that commented on this proposal generally did not support it because they did not think it would provide meaningful information.

56. Although the staff believes that the information necessary to provide such a disclosure is readily available to the entity preparing the fair value measurement for disclosure purposes, we agree with the respondents that said the disclosure would not be meaningful. This is because:

   (a) when assets and liabilities are not managed on a fair value basis (and are not recognised at fair value on the statement of financial position), it would not be cost beneficial for entities to make the assessment about within which level of the fair value hierarchy the item would be classified, particularly given the level of judgement involved with distinguishing between Level 2 and Level 3 fair value measurements in some situations

   (b) the disclosure would be 'boilerplate', which would not provide users with relevant information to evaluate the performance of the entity.

Staff recommendations

57. The staff recommends that the boards:

(a) (IASB only) affirm the proposed amendment to IAS 34 to require disclosures about fair value measurements for financial instruments in an entity's interim financial statements (paragraphs 44-45)

(b) require disclosures about fair value measurements only in periods *after initial recognition* (paragraph 47)

(c) require the same disclosure requirements for both recurring and nonrecurring fair value measurements, except for the Level 3 rollforward and information about transfers between Levels 1 and 2. These disclosures would be required for recurring measurements only (paragraphs 48-53)

(d) not require entities to disclose fair value information by level in the fair value hierarchy for items that are not measured at fair value in the statement of financial position (paragraphs 54-56).

Question 4
Do you agree with the staff recommendations in paragraph 57? If not, what do you propose and why?

Appendix – Summary of comment letters about the Level 3 sensitivity analysis disclosure proposal in the FASB's exposure draft

Operationality and Costs

1. The various issues raised by respondents are grouped in the following categories:

    a. The difficulties in using the concept of *reasonably possible alternative inputs*

    b. Multiple inputs and correlation among inputs

    c. Issues with using third-party pricing services

    d. Significant costs of revising and maintaining information systems

    e. Hedging of Level 3 positions with either Level 1 or Level 2 positions

    f. Issues of nonpublic entities, venture capital, and private equity firms

    g. Nonrecurring and nonfinancial Level 3 measurements.

2. Many respondents commented about the difficulty of implementing a sensitivity disclosure using the concept of *reasonably possible alternative inputs*. Several of these respondents suggested that additional clarification and guidance would be necessary, not only to help with the implementation, but also to increase the comparability among firms. One respondent noted that the requirement is very subjective and would be difficult to audit. Other respondents stated that the scope of *reasonably possible alternative inputs* was too broad and suggested using terms such as *more likely than not*, *probable*, or *likely alternative assumptions*. Two respondents suggested creating a standardized method to apply a sensitivity analysis.

3. Some of the more significant comments on this issue are reproduced below:

    > We would suggest the Board provide further guidance (perhaps by way of an illustrative example) to clarify the concept of "reasonably possible alternative inputs." We believe that different entities would interpret this requirement in different ways — some basing what is "reasonably possible" on past trends, others on future forecasts, and still others on the extremes of history.

    > We believe that the requirement to consider reasonably possible alternative inputs could be narrowed, and be made more operational and

> useful by considering a range based on likely alternative assumptions, or a similar notion. Since the ultimate goal is to provide useful information about a range of fair values, we believe that the focus should be more on the reasonable range that typically underlies any valuation analysis.
>
> We would recommend the FASB establish a standard set of criteria that will outline the required change in inputs for specific securities and derivatives. Without such criteria, significant judgment will be required by each organization to establish, and defend possible, significant, and alternative inputs; this could not only lead to a drastically different range of valuations for the same or similar financial products across organizations, but significantly greater workload for the auditor community to assess each unique valuation instance.

4. Many respondents commented that it would be operationally difficult to perform a sensitivity analysis for assets and liabilities that are valued using many inputs. These inputs are often correlated and many firms commented that it is difficult to capture the effect of correlation among the variables within a sensitivity analysis. Multiple respondents stated that it is also very difficult to provide a sensitivity analysis that incorporates all "reasonably possible alternative inputs" because this would require numerous permutations. For example:

> Valuation techniques commonly used in estimating the fair value of equity instruments (e.g. income approach, market approach) are often based on multiple techniques and a significant number of inputs, and we are therefore concerned that reporting entities may find it difficult to determine reasonably possible alternative inputs as a result of the numerous correlations between changes in significant inputs and the iterative changes they may cause.
>
> We believe that correlation cannot be reasonably captured in the calculation of sensitivity. This is consistent with other US GAAP guidance in ASC Topic 860-20-50-4, *Transfers and Servicing, Sales of Financial Assets – Disclosures*. That disclosure requires a sensitivity analysis specifying two or more unfavorable variations from expected levels, as opposed to reasonably possibly alternative inputs, and specifically excludes the effect of correlation.

5. Many respondents commented that they rely on third party pricing services to measure the fair value of many of their positions. The respondents stated that pricing services often use proprietary models and would be unwilling to share information about the inputs and assumptions used. One firm commented that providing proprietary information for Level 3 measurements may cause a loss of

competitive advantage. If pricing services did provide this information or perform the service for the client, many respondents noted that additional fees would be charged.

> Entities often use a pricing vendor (or broker) to determine level 3 fair value measurements. These vendors often have proprietary pricing models. Therefore, it may be difficult, if not impossible in certain circumstances, for an entity to effectively determine reasonably possible alternative level 3 inputs in these situations.

> The key inputs utilized in valuing Level 3 investment are often proprietary information. In an instance where there are relatively few of these types of Level 3 instruments, required disclosure of these key inputs in financial statements may cause a Registered Fund to publicly disclose information (in the nature of such key inputs) that the Fund believes is proprietary, thus giving up part of its competitive advantage.

6. A few respondents commented on the significant costs and difficulty associated with creating and maintaining accounting systems that would provide the required information.

> Most of MBA's members participating in developing this comment letter indicated that their accounting systems and asset subsystems are legacy systems that preceded the effective date of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), also referenced as Subtopic 820-10 in the FASB Accounting Standards Codification. Those systems have not and in some cases cannot be updated for FAS 157…Further, the recent frequency of FASB's refinements to FAS 157 and other pronouncements make it too expensive to update the complex legacy systems for the ever-changing accounting and disclosure rules landscape.

7. A few respondents noted that focusing on the sensitivity of Level 3 fair value measurements does not accurately show the counterbalancing effects of Level 1 and 2 assets and liabilities that are used to hedge Level 3 positions.

8. Nonpublic companies and private equity firms commented that a sensitivity disclosure would not be operational for them or useful for users of their financial statements. Many respondents stated that nonpublic entities should be exempt or the disclosure should be subjected to a further cost/benefit analysis because of limited in-house resources available. A significant number of private equity firms commented that a sensitivity disclosure would not be useful to their investors because of the valuation process used. One private equity firm commented that

most venture capital investments have binary results (success or failure) and no clear market inputs, and thus a sensitivity disclosure would provide a very wide range that would not be useful.

> VCF (Venture Capital Fund) investors know that they are invested for the long term. They know that returns are based on the segment of portfolio companies that succeed and they know that many fail. With this perspective, they see useful information in the quarterly updates they receive from the VCF general partner. They recognize the potential variability in these values but also recognize that the judgment of the venture capitalist who sits on the boards of the portfolio companies is the best gauge of fair value. They doubt the relevance of additional information based on hypothetical changes in quantitative inputs.

9. Some respondents noted that a sensitivity analysis is not relevant for nonrecurring nonfinancial instruments such as goodwill and fixed assets.

IFRS Approach

10. Several respondents commented that IFRS 7 *Financial Instruments: Disclosures,* is only applicable to financial instruments and is not required for nonfinancial instruments, which is required in the proposed Update. One respondent noted that because of PCAOB regulation, litigation risk, and SEC oversight, it is a much different environment under U.S. GAAP than under IFRS. A few respondents noted that IFRS 7 does not require entities to consider the correlation among changes in significant inputs.

Usefulness

11. A significant number of respondents commented that the information provided by the proposed sensitivity disclosures would not be useful because it would provide a wide range that would be meaningless and possibly more confusing to users. A few of those respondents stated that the fair value point estimate provided by management is the best estimate of value for the asset or liability and providing a range would only cause second guessing. Respondents also noted that because of the subjectivity involved in implementing a sensitivity analysis, comparability of information would be low.

12. Other respondents questioned the usefulness of the information due to the inability to capture correlation and interdependencies.

13. One user noted that the valuation of Level 3 assets is inherently subjective and that there should be more disclosure about the assumptions used to derive the value. This user further commented that having a sensitivity disclosure would allow users to better evaluate projected cash flows, earnings, capital requirements, and compliance with debt covenants.

> Enabling investors to analyze trends in fair value amounts and disclosures adds considerable value to investors. For instance, if the range of the increase or decrease in fair value due to changes in reasonably possible alternative assumptions changes over time for a particular asset class, that disclosure could provide valuable information to investors as to management’s view of the range of reasonably possible alternative assumptions and, therefore, the inherent volatility of the asset values.