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Exposure Draft ED/2010/7

Measurement Uncertainty Analysis Disclosure for Fair Value Measurements

Limited re-exposure of proposed disclosure

Comments to be received by 7 September 2010



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Exposure Draft
**MEASUREMENT UNCERTAINTY
ANALYSIS DISCLOSURE FOR
FAIR VALUE MEASUREMENTS**

**(Limited re-exposure
of proposed disclosure)**

Comments to be received by 7 September 2010

ED/2010/7

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APPROVAL BY THE BOARD OF *MEASUREMENT UNCERTAINTY ANALYSIS
DISCLOSURE FOR FAIR VALUE MEASUREMENTS* PUBLISHED IN JUNE 2010

BASIS FOR CONCLUSIONS

Introduction and invitation to comment

Background

The International Accounting Standards Board (IASB) is undertaking a project to provide guidance on measuring fair value when required or permitted by International Financial Reporting Standards (IFRSs). The objectives of that project are:

- to establish a single source of guidance for all fair value measurements required or permitted by IFRSs in order to reduce complexity and to improve consistency in their application;
- to clarify the definition of fair value and related guidance in order to communicate the measurement objective more clearly;
- to enhance disclosures about fair value measurements to help users of financial statements to assess the valuation techniques and inputs used to develop fair value measurements; and
- to increase the convergence of IFRSs and US generally accepted accounting principles (GAAP).

The IASB published an exposure draft *Fair Value Measurement* (ED/2009/5) in May 2009 addressing the objectives above. At their joint meeting in October 2009, the IASB and the US Financial Accounting Standards Board (FASB) agreed to work together to develop common fair value measurement and disclosure requirements in IFRSs and US GAAP. This exposure draft is a result of the boards' discussions.

Reasons for publishing this exposure draft

ED/2009/5 proposed a fair value hierarchy for the categorisation of fair value measurements of assets, liabilities and an entity's own equity instruments. The IASB and the FASB have tentatively decided to require entities to disclose a measurement uncertainty analysis for fair value measurements categorised within Level 3 of the fair value hierarchy unless another IFRS specifies that such a disclosure is not required for a particular asset or liability. When disclosing a measurement uncertainty analysis, an entity must take into account the effect of correlation between unobservable inputs, when relevant.

The requirement to take into account the correlation, if any, between unobservable inputs was not included in the disclosure proposals in ED/2009/5. This document addresses the proposed requirement for an entity to disclose a measurement uncertainty analysis for fair value measurements categorised

within Level 3 of the fair value hierarchy given the boards' decision to require an entity to take into account the effect of correlation between unobservable inputs in that analysis.

The IASB and the FASB will jointly consider the responses to this exposure draft and to the FASB's exposure draft of proposed amendments to Topic 820 *Fair Value Measurements and Disclosures* in the FASB *Accounting Standards Codification*TM. The proposal in this exposure draft is identical to the proposed measurement uncertainty analysis disclosure in the FASB's exposure draft of proposed amendments to Topic 820.

Invitation to comment

The Board invites comments on the questions set out below. Respondents need not comment on all questions. Comments are most helpful if they:

- (a) respond to the questions as stated,
- (b) contain a clear rationale, and
- (c) describe any alternatives that the Board should consider.

The Board is not requesting comments on the draft paragraph 1, the introduction to paragraph 2 and paragraph 2(b) set out in the exposure draft, or on matters not addressed in the exposure draft.

The IASB and the FASB will jointly consider all comment letters received on this exposure draft. All respondents are encouraged to submit one comment letter to the IASB. It is not necessary to submit letters to both the IASB and the FASB. However, the FASB will accept comment letters from its constituents on the proposal in this exposure draft. Please note that the proposal in this exposure draft is identical to the proposed measurement uncertainty analysis disclosure in the FASB's exposure draft of proposed amendments to Topic 820.

Comments should be submitted in writing and must arrive no later than **7 September 2010**.

Correlation between unobservable inputs

This exposure draft proposes that an entity should take into account the effect of correlation between unobservable inputs if such correlation is relevant when estimating the effect on a fair value measurement of a change in more than one unobservable input.

Question 1

Are there circumstances in which taking into account the effect of the correlation between unobservable inputs (a) would not be operational (eg for cost-benefit reasons) or (b) would not be appropriate? If so, please describe those circumstances.

Question 2

If the effect of correlation between unobservable inputs were not required, would the measurement uncertainty analysis provide meaningful information? Why or why not?

Alternatives to measurement uncertainty analysis

Question 3

Are there alternative disclosures that you believe might provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy that the Board should consider instead? If so, please provide a description of those disclosures and the reasons why you think that information would be more useful and more cost-beneficial.

Proposed Measurement Uncertainty Analysis Disclosure for Fair Value Measurements

This exposure draft presents in paragraph 2(a) a limited re-exposure of the disclosure proposed in paragraph 57(g) of the exposure draft *Fair Value Measurement* (ED/2009/5). Paragraph 1, the introduction to paragraph 2 and paragraph 2(b) have been added solely to place the proposed requirement in context.

Disclosure

- 1 An entity shall disclose information that helps users of its financial statements to assess both of the following:**
 - (a) for assets and liabilities that are measured at fair value in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements**
 - (b) 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.**

- 2 To satisfy the principles in paragraph 1, an entity shall disclose, at a minimum, the following information for each class of assets and liabilities measured at fair value in the statement of financial position after initial recognition:**
 - (a) a measurement uncertainty analysis for fair value measurements categorised within Level 3 of the fair value hierarchy. If changing one or more of the unobservable inputs used in a fair value measurement to a different amount that could have reasonably been used in the circumstances would have resulted in a significantly higher or lower fair value measurement, an entity shall disclose the effect of using those different amounts and how it calculated that effect. When preparing a measurement uncertainty analysis, an entity shall not take into account unobservable inputs that are associated with remote scenarios. An entity shall take into account the effect of correlation between unobservable inputs if such correlation is relevant when estimating the effect on the fair value measurement of using those different amounts. For that purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, with respect to total equity.**

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- (b) for fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement.

Appendix
[Draft] Amendment to IFRS 7 *Financial Instruments:*
Disclosures

The amendment in this appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies [draft] IFRS X Fair Value Measurement for an earlier period, it shall apply the amendment for that earlier period.

The amendment in paragraph A1 is unchanged from the proposal in paragraph D10 of ED/2009/5.

IFRS 7 *Financial Instruments: Disclosures*

A1 Paragraph 27B(e) is deleted.

[Draft] Illustrative example

This [draft] example accompanies, but is not part of, [draft] IFRS X Fair Value Measurement.

Example 1—Measurement uncertainty analysis

- IE1 For fair value measurements categorised within Level 3 of the fair value hierarchy, the [draft] IFRS requires an entity to provide a measurement uncertainty analysis. The objective of that analysis is to provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy at the measurement date.
- IE2 To meet that objective, the [draft] IFRS requires an entity to take into account the effect of correlation between unobservable inputs if such correlation is relevant when estimating the effect on the fair value measurement of a change in an unobservable input.
- IE3 When disclosing how an entity calculated the effect on the fair value measurement of changing one or more of the unobservable inputs to a different amount that could have reasonably been used in the circumstances, an entity might compare the unobservable inputs used in the fair value measurement with the different amounts used in the measurement uncertainty analysis.
- IE4 An entity might disclose the following for assets when applying paragraph 2(a) of the [draft] IFRS:

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Measurement uncertainty analysis for fair value measurements using significant unobservable inputs (Level 3)				
(CU in millions)				
	Fair value at 31/12/X9	Difference in fair value from using different unobservable inputs that could have reasonably been used		Significant unobservable inputs
		Increase in fair value	Decrease in fair value	
Debt securities:				
Residential mortgage-backed securities	125	24	(18)	Prepayment rates, probability of default, severity of loss, yield (including the effect of correlation between prepayment rates and probability of default)
Commercial mortgage-backed securities	50	13	(6)	Probability of default, severity of loss, yield
Collateralised debt obligations	35	5	(3)	Implied collateral valuation, default rates, housing prices
Total debt securities	<u>210</u>	<u>42</u>	<u>(27)</u>	
Hedge fund investments:				
High-yield debt securities	90	5	(3)	Fund investment statements
Total hedge fund investments	<u>90</u>	<u>5</u>	<u>(3)</u>	
Unquoted equity instruments:				
Private equity investments	25	4	(3)	Fund investment statements
Other equity investments	10	3	(2)	Investee financial statements
Total unquoted equity instruments	<u>35</u>	<u>7</u>	<u>(5)</u>	
Derivatives:				
Credit contracts	38	6	(5)	Volatility of credit
Total derivatives	<u>38</u>	<u>6</u>	<u>(5)</u>	
Investment properties:				
Asia	13	2	(3)	Adjustments to comparable property values
Europe	15	2	(2)	Adjustments to comparable property values
Total investment properties	<u>28</u>	<u>4</u>	<u>(5)</u>	
Total	<u>401</u>	<u>64</u>	<u>(45)</u>	

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

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- IE5 In addition, an entity should provide any other information that will help users of its financial statements to evaluate the quantitative information disclosed. For example, an entity might describe the relative subjectivity and limitations of the unobservable inputs and the range of unobservable inputs used.

Approval by the Board of *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* published in June 2010

The exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* was approved for publication by the fifteen members of the International Accounting Standards Board.

Sir David Tweedie Chairman

Stephen Cooper

Philippe Danjou

Jan Engström

Patrick Finnegan

Robert P Garnett

Gilbert Gélard

Amaro Luiz de Oliveira Gomes

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James J Leisenring

Patricia McConnell

Warren J McGregor

John T Smith

Tatsumi Yamada

Wei-Guo Zhang

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the exposure draft.

Introduction

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board in reaching the conclusions in the exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*. It includes the reasons for accepting particular views and for rejecting others. Individual Board members gave greater weight to some factors than to others.
- BC2 The proposal in the exposure draft is the result of the IASB's discussions with the US Financial Accounting Standards Board (FASB) about measuring fair value and disclosing information about fair value measurements.
- BC3 The FASB has developed a basis for conclusions to accompany its exposure draft of proposed amendments to Topic 820 *Fair Value Measurements and Disclosures* in the FASB *Accounting Standards Codification*TM (which codified FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157)). That basis for conclusions summarises the FASB's considerations in reaching its conclusions about the proposed measurement uncertainty analysis disclosure.

Background

- BC4 In May 2009 the Board published an exposure draft *Fair Value Measurement* (ED/2009/5) proposing a fair value hierarchy for the categorisation of fair value measurements of assets, liabilities and an entity's own equity instruments. ED/2009/5 also proposed that an entity should provide a measurement uncertainty analysis disclosure about fair value measurements categorised within Level 3 of the fair value hierarchy (ie fair value measurements using significant unobservable inputs). That proposal did not require an entity to take into account interdependencies or correlation between inputs. That proposal also did not specify whether an entity should provide an analysis of changes in observable inputs or unobservable inputs, or both.
- BC5 The Board proposed a measurement uncertainty analysis disclosure requirement to provide users of financial statements with a sense of the potential measurement uncertainty of fair value measurements categorised within Level 3 of the fair value hierarchy, particularly given

that fair value measurements determined using valuation techniques are more subjective than those derived from an observable market price. The Board thought that information about the use of valuation techniques should be disclosed, including the sensitivities of fair value measurements to the main valuation assumptions.

- BC6 IFRS 7 *Financial Instruments: Disclosures* requires an entity to disclose information about the sensitivities of fair value measurements to the main valuation assumptions (ie a measurement uncertainty analysis) for financial instruments categorised within Level 3 of the fair value hierarchy (that disclosure would be removed from IFRS 7 once the fair value measurement standard is finalised). That disclosure does not require an entity to take into account the effect of interdependencies or correlation between unobservable inputs.

Convergence with US generally accepted accounting principles (GAAP)

- BC7 At their joint meeting in October 2009, the IASB and the FASB agreed to work together to develop common fair value measurement guidance, including the requirements for disclosures about fair value measurements. The boards began their joint discussions to develop such guidance in January 2010 and completed their initial discussions in March 2010. The exposure draft is a result of those discussions.
- BC8 The FASB published an exposure draft of proposed amendments to Topic 820 in June 2010. The proposals in that exposure draft include a measurement uncertainty analysis disclosure for fair value measurements categorised within Level 3 of the fair value hierarchy, unless another Topic specifies that such a disclosure is not required for a particular asset or liability. For example, in its project on accounting for financial instruments, the FASB has concluded that a measurement uncertainty analysis disclosure would not be required for investments in unquoted equity instruments.
- BC9 The IASB and the FASB will resume their discussions about fair value measurement after the exposure periods of their respective exposure drafts end. The boards will jointly consider the comments received on the proposal in the exposure draft and on the FASB's exposure draft of proposed amendments to Topic 820.

Measurement uncertainty analysis

- BC10 The Board concluded that the objective of a measurement uncertainty analysis disclosure is to provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy at the measurement date. The proposed disclosure is not intended to reflect remote (including worst-case) scenarios and it is not forward looking (ie the analysis in the proposed disclosure is not meant to predict how a fair value measurement would change in the future because of changes in future economic conditions).
- BC11 Users of financial statements have informed the Board that the measurement uncertainty analysis disclosure required by IFRS 7 provides useful information that helps them to assess the subjectivity of an entity's fair value measurements categorised within Level 3 of the fair value hierarchy.

Scope

- BC12 The exposure draft proposes that an entity should be required to provide a measurement uncertainty analysis disclosure about fair value measurements that are categorised within Level 3 of the fair value hierarchy unless another IFRS specifies that such a disclosure is not required for a particular asset or liability. In developing ED/2009/5, the IASB did not limit the application of the proposed disclosure to particular assets or liabilities. The proposals in the exposure draft would not apply to assets or liabilities not measured at fair value in the statement of financial position.
- BC13 The scope of the exposure draft is unchanged from the scope in ED/2009/5.

Reasonably possible alternative assumptions

- BC14 ED/2009/5 proposed that an entity should disclose the effect on the fair value measurement if using 'reasonably possible alternative assumptions' would affect the fair value measurement significantly. It did not define 'reasonably possible' or 'significantly'. It also did not specify whether reasonably possible alternative assumptions relate to observable inputs, unobservable inputs or both.

- BC15 In its subsequent deliberations, the Board decided to avoid using the term 'reasonably possible alternative assumptions' for the following reasons:
- (a) That term has created confusion in practice for entities applying IFRS 7. This has led to inconsistency in application because different entities have different interpretations of what is 'reasonably possible'. As a result, the Board decided instead to describe the objective of the disclosure.
 - (b) The term 'reasonably possible' has a specific meaning in US GAAP and therefore could not be used in a common standard.
- BC16 The Board decided to specify that entities should assess the effect on the fair value measurement of changing one or more *unobservable* inputs. The Board concluded that entities should not need to assess how *observable* inputs might have differed, particularly because the disclosure is about measurement uncertainty (there is little, if any, uncertainty about observable inputs). In addition, the Board noted that the disclosure is not meant to provide users of financial statements with information for 'second guessing' an entity's fair value measurements.
- BC17 The Board also considered whether to provide additional guidance about what is meant by the term 'significantly'. ED/2009/5 stated that 'assessing the significance of a particular input to the entire measurement requires judgement, considering factors specific to the asset or liability'. The proposed measurement uncertainty analysis disclosure in the exposure draft states that 'significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, with respect to total equity.' The Board noted that assessing significance requires judgement and decided not to provide guidance about what is meant by 'significantly'.

Correlation between inputs

- BC18 ED/2009/5 did not propose requiring an entity to take into account the effect of correlation between unobservable inputs in the proposed measurement uncertainty analysis disclosure. However, users of financial statements have informed the Board that the proposed measurement uncertainty analysis disclosure (and that required by IFRS 7) would be more helpful if it required the effect of correlation between unobservable inputs to be taken into account in the measurement uncertainty analysis. They have asserted that including the effect of correlation would help them to assess the extent to which using a different unobservable input can affect a fair value measurement.

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- BC19 Therefore, the Board concluded that the measurement uncertainty analysis disclosure would be more meaningful if an entity were to take into account the correlation between unobservable inputs, when such correlation is relevant. The Board considered whether to require an entity to include the effect of correlation between observable inputs or unobservable inputs, or both. The Board believes that the selection of another unobservable input that could have reasonably been used in the circumstances would be limited to those that were reasonable given the observable inputs used in the fair value measurement. As a result, the proposal in the exposure draft specifies that the effect of correlation should be taken into account only for unobservable inputs.
- BC20 The Board also concluded that an entity should not be required to disclose quantitative information about the degree of correlation between unobservable inputs (eg it is not necessary to perform a statistical analysis such as a regression analysis using two independent variables to determine the r-squared). Rather, an entity would need to determine whether using a different combination of unobservable inputs that would have resulted in a significantly higher or lower fair value measurement would have a consequential effect on any of the other unobservable inputs used in the valuation technique (such as when using a pricing model) to measure fair value. If so, the entity would disclose the effect on the fair value measurement of using that combination of unobservable inputs in that pricing model.
- BC21 The Board is aware that requiring an entity to take into account the effect of correlation between unobservable inputs has practical considerations, including how to determine which unobservable inputs are correlated with each other and the effect of that correlation on the fair value measurement. However, the Board concluded that the measurement uncertainty analysis would be most informative when correlation between unobservable inputs is taken into account. An assessment of the effect of correlation between unobservable inputs and whether the effect of such correlation is relevant is a matter of judgement and would differ depending on the circumstances. Therefore, the Board decided not to provide guidance for making assessments about the effect of correlation between unobservable inputs.

Comparison with IFRS 7's market risk sensitivity analysis disclosure

- BC22 In addition to requiring a measurement uncertainty analysis about fair value measurements, IFRS 7 requires a sensitivity analysis about an entity's exposure to market risks (ie interest rate risk, currency risk or other price risk). Some respondents to ED/2009/5 questioned whether the proposed measurement uncertainty analysis disclosure is necessary given the potential overlap with the market risk disclosure requirement in paragraph 40 of IFRS 7.
- BC23 The Board concluded that even though there is some overlap in those disclosures, the objective of each disclosure is different: the market risk sensitivity analysis disclosure provides information about an entity's exposure to market risks, whereas the fair value measurement disclosure provides information about the measurement uncertainty related to those fair value measurements with the greatest level of subjectivity (ie fair value measurements categorised within Level 3 of the fair value hierarchy). In addition, the IFRS 7 market risk sensitivity analysis disclosure relates only to financial instruments, whereas the measurement uncertainty analysis disclosure proposed in ED/2009/5 relates to all assets and liabilities measured at fair value (unless another IFRS specifies that such a disclosure is not required for a particular asset or liability).
- BC24 In reaching that conclusion, the Board identified the following differences between those disclosures:
- (a) the market risk disclosure is not specific to financial instruments measured at fair value, but also relates to financial instruments measured at amortised cost.
 - (b) the market risk disclosure focuses on the effect on profit or loss and equity, not specifically on the change in value.
 - (c) the market risk disclosure focuses only on the entity's exposure to market risks (ie interest rate risk, currency risk or other price risk), whereas the measurement uncertainty analysis takes into account the effect on a fair value measurement of all significant unobservable inputs.
 - (d) the market risk disclosure does not distinguish between observable and unobservable inputs (or level in the fair value hierarchy, ie Level 1, 2 or 3), whereas the measurement uncertainty analysis disclosure relates only to the unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy.

Benefits and costs

- BC25 The objective of financial statements is to provide information about an entity's financial position, financial performance and cash flows that is useful to a wide range of users for economic decisions. To attain that objective, the Board endeavours to ensure that a proposed IFRS or an amendment to an IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs to implement a new standard might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.
- BC26 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the Board considers the following:
- (a) the costs incurred by preparers of financial statements;
 - (b) the costs incurred by users of financial statements when information is not available;
 - (c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information; and
 - (d) the benefit of better economic decision-making as a result of improved financial reporting.
- BC27 The proposed disclosure about the measurement uncertainty related to fair value measurements categorised within Level 3 of the fair value hierarchy would improve the quality of information provided to users of financial statements. Providing information that is useful to a wide range of users in making economic decisions is the objective of financial statements in the *Framework*. In developing the proposed disclosure requirement in the exposure draft, the Board obtained input from users and auditors of financial statements and other interested parties to assess whether the disclosure would provide useful information. The Board also noted that some regulators have recommended that an entity should provide information about the effect on a fair value measurement of correlation between inputs when such correlation is relevant, even though such information is not currently required in IFRS 7.
- BC28 The proposed requirement to provide information about the effect on a fair value measurement of correlation between unobservable inputs builds upon the current requirement in IFRS 7 to provide a measurement uncertainty analysis for fair value measurements categorised within

Level 3 of the fair value hierarchy. Even so, the assessment of the effect of correlation may result in a change to practice for some entities, particularly for those not providing a measurement uncertainty analysis today (eg for non-financial assets and liabilities measured at fair value but for which a measurement uncertainty analysis is not required). However, the Board noted that when performing an impairment test in accordance with IAS 36 *Impairment of Assets*, an entity must provide a sensitivity analysis, including the effect of correlation between inputs, when the recoverable amount of an asset is determined on the basis of its fair value less costs to sell.

- BC29 Furthermore, some entities would need to make systems and operational changes, thereby incurring incremental costs. Some entities might also incur incremental costs in applying the proposal. However, the Board believes that the benefits resulting from increased transparency about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy and the improved communication of that measurement uncertainty to users of financial statements would be ongoing. On balance, the Board concluded that the proposal in the exposure draft, if confirmed, would improve financial reporting.