Australian Government

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

Exposure Draft ED/2010/7
Measurement Uncertainty Analysis Disclosure for Fair Value Measurements

The Australian Accounting Standards Board (AASB) is pleased to provide its comments on Exposure Draft ED/2010/7 *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*. In formulating these comments, the AASB sought and considered the views of Australian constituents. The comment letters received are published on the AASB's website.

Overall view

The AASB agrees with the ED's objective to require information to help users assess the subjectivity of fair value measurements categorised within Level 3 of the fair value hierarchy. However, the AASB has reservations about the proposed manner in which that objective would be met. The proposed requirement to disclose a measurement uncertainty analysis could be taken to infer precision that is not attainable or cast unnecessary doubt on the determined value.

The proposed disclosure seemingly requires consideration of a range of many and varied alternatives in recalculating estimates of fair value, rather than alerting users to the specific areas of uncertainty that could change fair value significantly. Focusing on discrete ranges of uncertainty may erroneously imply that any amount within that range would be an acceptable measure of fair value. The AASB does not consider it the role of financial statements to disclose recalculated estimates of fair value.

The AASB recommends that the disclosure principle focuses on the major sources of uncertainty about the inputs used that would have a significant impact on the fair value measurement and proposes an alternative disclosure that is likely to be more useful to users of financial statements (see below). In addition, the AASB recommends that the principle requires incorporation and disclosure of the effect of correlation between inputs, whether observable or unobservable, where information about inputs alone would otherwise be misleading.

The AASB's proposed alternative disclosure requirement could be worded along the following lines:

> "for fair value measurements categorised within Level 3 of the fair value hierarchy, an entity shall disclose:
>
> (a) the major sources of uncertainty, if any, about the inputs used that would change fair value significantly; and
>
> (b) the effect of correlation between inputs, whether observable or unobservable, where information about inputs alone would otherwise be misleading."

The proposed alternative disclosure could be made in the form of a sensitivity analysis. However, a sensitivity analysis should not be expressly required.

The proposed alternative is consistent with the proposed disclosures in paragraph 57(g) of ED/2009/5 *Fair Value Measurement*, amended to incorporate and disclose the effect of correlation. The AASB's proposed alternative does not refer to the phrase "reasonably possible alternative assumptions" exposed in paragraph 57(g) of ED/2009/5, to eliminate confusion associated with its meaning. Such disclosures would also be consistent with those specified by paragraph 27B(e) of IFRS 7 *Financial Instruments: Disclosures*.

The AASB is also concerned that the proposed extent of disclosure required for a measurement uncertainty analysis will be costly and burdensome for preparers. These costs could conceivably discourage entities from applying fair value options available in IFRSs. The AASB considers that its proposed alternative disclosures would result in a better balancing of costs and benefits than would the presentation of a measurement uncertainty analysis as proposed in ED/2010/7.

Comments that apply if the IASB proceeds with its proposals

If the IASB proceeds with its proposals in ED/2010/7, the AASB recommends that the IASB considers the specific concerns and other comments set out below.

Clarification of wording

The AASB supports the proposed removal of "reasonably possible alternative assumptions" from the wording exposed in paragraph 57(g) of ED/2009/5. However, the wording proposed in paragraph 2(a) of ED/2010/7 may have some shortcomings and should be improved to help avoid inconsistent disclosures.

The AASB also has some concerns with the [Draft] Illustrative example accompanying the ED.

The AASB's specific concerns regarding these matters are set out in Appendix B.

Appropriateness of proposals for some non-financial assets

Many items of property, plant and equipment are specialised in nature, for example, infrastructure assets, and therefore are not traded in an active market. The AASB is concerned that it is unclear how the proposals should be applied to non-financial assets measured, for example, at depreciated replacement cost (DRC) using significant Level 3 inputs, particularly because examples or other guidance for these assets were not included in the ED.

If the IASB mandates the disclosures proposed in ED/2010/7, it should either provide guidance on their application to non-financial assets, particularly property, plant and equipment, or exclude non-financial assets other than investment property from the scope of those disclosures.

Unobservable and observable inputs
The AASB considers the IASB's proposal to take into account only the effect of correlation between unobservable inputs is unduly limiting. If observable and unobservable inputs are correlated in a Level 3 fair value measurement, the effect of that correlation should be taken into account. This is likely to provide more useful information to users about the level of uncertainty of fair value measurements that use significant unobservable inputs.

The AASB's specific comments on the questions in the ED are set out in Appendix A.

If you have any queries regarding any matters in this submission, please contact me or Mischa Ginns (mginns@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson
Chairman and CEO

APPENDIX A

AASB's Specific Comments on the Questions in ED/2010/7

Question 1
Are there circumstances in which taking into account the effect of the correlation between unobservable inputs (a) would not be operational (e.g., for cost-benefit reasons) or (b) would not be appropriate? If so, please describe those circumstances.

Appropriateness of taking into account the effect of the correlation between unobservable inputs

The AASB considers that, whenever the effects of correlation between inputs (whether observable or unobservable) to a fair value measurement are significant, they need to be taken into account if the fair value measurement is to be representationally faithful. A dynamic model for incorporating the effects of correlation between inputs would need to be applied for the information to be useful. However, we think it unnecessary to require the use of correlation in all cases.

Costs versus benefits

The proposed disclosures in the ED are likely to be costly to make, particularly because a dynamic model for incorporating the effects of correlation would seem necessary. The cost involved in preparing the proposed disclosures may discourage entities from applying fair value options available in IFRSs.

Some entities with financial instruments measured at fair value using valuation techniques categorised within Level 3 of the fair value hierarchy have the models and detailed information to be able to take into account a range of indices and other inputs without too much difficulty. Such information, which would be required for the alternative disclosures the AASB recommends (see covering letter), would be necessary for pricing decisions the entities would customarily make regarding those instruments. However, to make the disclosures proposed in ED/2010/7, entities may need to incur significant additional costs in developing the systems to take into account a range of inputs in the process of determining a reasonable range of measurement uncertainty relating to fair values of assets and liabilities categorised within Level 3 of the fair value hierarchy.

When fair value measures of non-financial assets are based on valuations prepared by external valuers, the information required for the proposed disclosures is likely to considerably increase the cost of obtaining the valuations.

As noted in the covering letter, a further potential cost of the disclosures proposed in the ED is that applying them may, in various instances, imply a greater degree of precision of the range of reasonable uncertainty than is attainable, and thus be misleading.

Appropriateness of correlation proposals for some non-financial assets

The AASB seeks clarification about how to apply the proposals to non-financial assets measured, for example, at DRC as an estimate of fair value, when DRC[1] incorporates significant unobservable inputs.

[1] Depending on the circumstances, DRC may include Level 2, Level 3 or a combination of Level 2 and 3 inputs.

The ED's guidance on the content of a measurement uncertainty analysis could be taken to imply there might be nothing to disclose in respect of fair value measurements based on DRC. DRC estimates include assumptions about such matters as the asset's useful life. However, an entity must use its best estimate of useful life, so it seems difficult to argue that "a different amount could reasonably have been used in the circumstances", which is the key to the disclosures required.

The AASB considers it unclear whether exit prices, for example, scrap values for specialised equipment, would qualify as "a different amount that could have reasonably been used in the circumstances" when DRC incorporates significant unobservable inputs (i.e., is categorised at Level 3 of the fair value hierarchy). The AASB considers that such a price would not be an acceptable alternative to DRC in the circumstances in which DRC is the best measure of fair value. However, because fair value is defined as an exit price in ED/2009/5, there is a risk of confusion surrounding this issue.

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?

No. The AASB considers that if the effect of any significant correlation between unobservable inputs were not required, the measurement uncertainty analysis would not provide meaningful information.

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.

Alternative disclosures
The objective of the disclosures would be better met if the AASB's proposed alternative is considered. The proposed alternative suggests taking into account the major sources of uncertainty about the inputs used that would have a significant impact on the fair value measurement as well as incorporating and disclosing the effect of correlation between inputs, whether observable or unobservable, where information about inputs alone would otherwise be misleading.

Additional disclosures
To the extent the effect of correlation is disclosed the AASB considers that it would be useful to require disclosure of how the extent of correlation was determined.

APPENDIX B

AASB's additional comments on ED/2010/7

If the IASB proceeds with its proposals in ED/2010/7, the AASB recommends consideration of the following comments.

Clarification of the wording of the disclosure requirements
The AASB considers that the wording of paragraph 2(a) of ED/2010/7 is unclear, which may result in inconsistent disclosures. The AASB therefore encourages the IASB to be more descriptive about how to apply the proposed disclosures.

There are two phrases in paragraph 2(a) of the ED that are of particular concern. Firstly, the phrase "...a different amount that could have reasonably been used..." is unclear regarding the extent of the deviation that preparers should consider when determining a different amount. This may result in inconsistencies between entities in how they make the disclosures proposed in the ED.

The second related phrase that is of concern, "...an entity shall not take into account unobservable inputs that are associated with remote scenarios..." may cause some confusion. For example, if the probability threshold for determining whether an input is associated with a remote scenario is ten percent, does this mean that an input with a probability greater than ten percent is considered reasonable and therefore should be disclosed as a 'different amount'? The reference to remote scenarios is likely to expand the scope of what is considered reasonable and may result in disclosures that are not useful. The AASB therefore encourages the IASB to consider removing the reference to remote scenarios from the proposed disclosure requirements.

[Draft] Illustrative example
The AASB has the following concerns regarding aspects of the [Draft] Illustrative example as presented on page 11 of the ED:

(a) The AASB questions whether some of the inputs mentioned in the example, namely, 'fund investment statements' and 'investee financial statements', are appropriate. This is because they are sources of evidence rather than inputs.

(b) The AASB considers the input 'adjustments to comparable property values' to be more representative of a Level 2 input, and therefore questions why it is presented in the example as a significant unobservable input.