

Issues Paper – AASB ED 199 (IASB ED/2010/7)

Measurement Uncertainty Analysis Disclosure for Fair Value Measurements

1. This paper discusses the issues identified by AASB staff in relation to AASB Exposure Draft ED 199 *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* (incorporating IASB ED/2010/7). This paper includes:
 - (A) background to ED 199;
 - (B) staff analysis addressing issues identified in ED 199;
 - (C) IASB questions and AASB staff recommendations on the proposals in ED 199; and
 - (D) consideration of Reduced Disclosure Requirements (RDR).
- (A) **Background**
2. AASB ED 199 (IASB ED/2010/7) proposes to expand on the proposals in AASB ED 181 *Fair Value Measurement* (IASB ED/2009/5). ED/2009/5, published in May 2009, proposes replacing fair value measurement guidance contained in individual IFRSs with a single standard incorporating a common definition for fair value, fair value disclosure requirements and guidance on how to measure fair value.
3. The IASB's objective for the proposed disclosure requirements in ED/2009/5 affected by the proposals in ED/2010/7 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. This is because those fair value measurements are more subjective than those derived from observable market prices. However, ED/2009/5 does not propose to require that entities take into consideration the effect of correlation between unobservable inputs in the analysis. Based on IASB and FASB deliberations on comments received from constituents, the Boards decided to separately expose further issues that were not included in ED/2009/5. This resulted in the publication of ED/2010/7 by the IASB in June 2010.
4. ED/2010/7 proposes requiring disclosure of a measurement uncertainty analysis for fair value measurements that use significant unobservable inputs (Level 3 of the fair value hierarchy) for each class of assets and liabilities measured at fair value that takes into account the effect of correlation between unobservable inputs, if relevant.

(B) Staff Analysis of Proposals

5. AASB staff agrees with the objective of the proposals in ED 199. Taking into account the effect of correlation between unobservable inputs would, in principle, constitute an improvement on the proposals in ED 181 and is likely to provide more decision-useful information for users of financial statements, particularly since:
 - (a) the proposals clarify that the disclosures originally proposed in paragraph 57(g) of ED 181 are to be focused on unobservable inputs only, rather than also considering observable inputs, which would take into account market risk; and
 - (b) removing the phrase ‘reasonably possible alternative assumptions’ addresses some confusion associated with the meaning of this phrase and also aligns with US GAAP.

6. Though we support the objective of the proposals in ED/2010/7, AASB staff are concerned that:
 - (a) the proposed wording lacks clarity regarding the extent of correlation that needs to be considered;
 - (b) the unit of account that is proposed may not be appropriate in all circumstances;
 - (c) the application of the proposals to non-financial assets that are measured at depreciated replacement cost as an estimate of fair value is unclear and may not be practicable; and
 - (d) it imposes significant costs on preparers.

(a) Clarification of the wording of the disclosure requirements
7. AASB staff support the improvement in the wording of the proposed disclosure requirements. However, we have concerns that the wording is still unclear and may result in inconsistencies in application and presentation.

8. The proposed requirements are not clear about:
 - (i) the order in which the relevant variables are considered and the effects of correlation; and
 - (ii) the extent of deviation that should be considered.

(i) Order effects of correlation

9. It is not clear whether entities will be required to take into account only the first order effects of correlation or whether further (e.g., second and third order) effects of correlation also need to be considered. For example, in the table in Illustrative Example 1 of ED/2010/7 (page 11), assume the change in prepayment rates impacts probability of default and severity of loss. The impact on the probability of default and severity of loss may have a further impact on the yield. Are preparers required to take into account only the direct effect of correlation i.e. the impact on the probability of default and severity of loss, or are preparers also required to take into account the indirect impact, i.e. the impact on the yield? The effect of correlation between all these inputs may be ‘relevant’ and therefore may be required to be taken into account in the measurement uncertainty analysis, but this is unclear.
10. In principle, the order in which the various inputs are considered should not change the outcome, which would mean a dynamic model would need to be applied.

(ii) Extent of deviation that should be considered

11. AASB staff support the proposed removal of ‘reasonably possible alternative assumptions’ from the wording exposed in ED 181. However, the wording proposed in ED 199 may have some shortcomings. The phrase in paragraph 2(a) of ED 199 “...a different amount that could have reasonably been used...” is vague and therefore lacks clarity about the extent of the deviation that preparers should consider when using a different amount. This vagueness may result in inconsistencies between entities in how they make the disclosures proposed in ED 199.
12. The lack of clarity within the proposed wording may be corrected by including some guidance and further examples about the level of correlation that needs to be considered. In developing such guidance, the focus should be on keeping it principle-based and not too prescriptive.

(b) Unit of account

13. The proposals require entities to disclose information for each class of assets and liabilities measured at fair value. It is unclear whether the effect of correlation needs to be considered at a class level or at a lower level, if relevant. AASB staff are concerned

that useful information may be omitted if the effects of correlation on individual assets or liabilities is not taken into account as well. Some individual assets or liabilities within a class of assets or liabilities may have different unobservable inputs that are correlated with those of other individual assets or liabilities within a class. It is not clear whether the correlations between individual assets and liabilities within a class are expected to be taken into account.

14. To require meaningful information about the extent to which items are correlated, it may be beneficial to require entities to consider correlation on each individual asset and liability for which the effect of correlation is significant. AASB staff acknowledge that calculating the effect of correlation on an individual asset and liability basis may be onerous for preparers, which raises the question regarding the cost versus the benefit of these disclosures (discussed below in (d)).

(c) Non-financial assets

15. We are concerned that the application of the proposals to non-financial assets that are measured at depreciated replacement cost as an estimate of fair value is unclear and may not be practicable. This is likely to be a significant issue in the Australian public sector, in which many entities are required to revalue property, plant and equipment to fair value. Many items of property, plant and equipment are specialised in nature (for example, infrastructure assets) and therefore are not traded in an active market. Therefore, it is likely that many revalued items of property, plant and equipment would be measured under Level 3 of the fair value hierarchy.
16. We think it is confusing that:
 - (a) the first sentence of paragraph 2(a) of ED 199 makes an unqualified statement that a measurement uncertainty analysis must be disclosed for fair value measurements at level 3 of the fair value hierarchy; but
 - (b) the ED's guidance on the content of such an analysis implies there might be nothing to disclose in respect of fair value measurements based on depreciated replacement cost (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).

17. We think the IASB should clarify whether exit prices (e.g., scrap values for specialised equipment) would qualify as “a different amount that could have reasonably been used in the circumstances” [ED 199, paragraph 2(a)] when depreciated replacement cost (DRC) is used at Level 3 of the fair value hierarchy. Our interpretation is that such a price would not be an acceptable alternative to DRC in the circumstances in which DRC is appropriate evidence of fair value. However, because fair value is defined as an exit price in ED 181, there is a considerable risk of confusion surrounding this issue.
18. Furthermore, we think the absence of an illustrative example or other guidance on making the proposed disclosures in respect of non-financial assets other than investment properties is a significant omission from the ED. It is not apparent that the IASB gave much consideration to the application of the proposed disclosure to non-financial assets like property, plant and equipment.
19. In conclusion, we think that, if the IASB mandates the disclosures proposed in ED 199, it should either explain their application to non-financial assets (particularly, for example, to property, plant and equipment) or exclude non-financial assets other than investment property from the scope of those disclosures.

(d) Cost vs benefit

20. Even though AASB staff support the objective of the proposals, we are concerned that the proposed level of disclosure will be a costly and burdensome exercise for preparers. This is particularly because we think a dynamic model for incorporating the effects of correlation between unobservable inputs would need to be applied for the information to be useful. The cost involved in preparing the proposed disclosures may discourage preparers from applying fair value options available in IFRSs.
21. The proposals in ED 199 are intended to address concerns regarding the subjectivity and level of uncertainty of fair value measurements categorised within Level 3 of the fair value hierarchy. However, the proposals would require entities to take into account effects of correlation that may be difficult to determine reliably (particularly for assets

not measured using discounted cash flow analysis). Therefore, it is not clear whether taking in account the effect of correlation will improve the quality of information provided to users.

22. We note that some entities with significant financial instruments measured at fair value using valuation techniques have the models and level of information to be able to take into account a range of indices without too much difficulty. However, the majority of preparers may not have the systems and capabilities to consider a range of indices in the process of determining the measurement uncertainty relating to the fair value of assets and liabilities. A further cost is that the proposals would give a misleading impression of accuracy about the range of Level 3 fair values.
23. When fair value measures are based on valuations prepared by external valuers, it is unclear whether the information required for this disclosure would be available, and at what cost.

(C) IASB Questions and AASB Staff Suggestions

24. The IASB has requested comment on 3 questions in ED 199. The questions raised by the IASB and AASB tentative views are:

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.

25. AASB staff's concerns regarding cost vs benefit are discussed in paragraphs 20 – 23.

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?

26. AASB staff think if the effect of correlation between unobservable inputs were not required, the measurement uncertainty analysis would not provide meaningful

information. However, if the effect of correlation is taken into account, for information to be useful we think a dynamic model would need to be applied.

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.

Additional disclosures

27. As part of the proposed disclosure requirements, it may be useful to disclose how the extent of correlation was determined. Even though this level of detail is not required, preparers are likely to perform detailed calculations in order to determine whether the effect of correlation is significant and therefore it should not be overly burdensome to require entities to disclose more detail in this regard.

Alternative disclosures

28. The objective of the disclosures would be better met if the proposals in paragraph 57(g) of ED 181 were retained largely unaltered, but incorporate the useful improvements to the wording noted in paragraph 5 above.

(D) RDR Considerations (not for submission but for future development)

29. The tentative view of AASB staff is that the proposed disclosure requirements in ED 199 should not be applied by entities adopting the RDR. This is consistent with other AASB standards where fair value disclosures are not required under the RDR. AASB staff note that many fair value disclosures are not included in the RDR as there is no equivalent in the *IFRS for SMEs*.