

Limited re-exposure of fair value measurement disclosures

The International Accounting Standards Board (IASB) released an exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* on 29 June 2010 (the June 2010 ED). The June 2010 ED is a limited re-exposure of certain proposed disclosure requirements for fair value measurements, when fair value is required or permitted by IFRS.

Specifically, the June 2010 ED proposes that the effect of correlation between unobservable inputs must be considered, if relevant, when estimating the effect of using those different unobservable inputs on fair value. That is, when a change in one unobservable input would affect one or more of the other unobservable inputs used, that correlation must be considered when determining the amount by which fair value might have changed, had a different unobservable input been used.

How does the June 2010 ED fit into the project on *Fair Value Measurement*?

The June 2010 ED is a part of the IASB's *Fair Value Measurement* project to provide guidance on **how** to measure fair value, when fair value is required or permitted by IFRS. As a part of this project, the IASB hopes to enhance disclosures about fair value and help users assess the valuation techniques and inputs used to measure fair value. The IASB's proposals do not change **when** an entity is required to use fair value, but rather, provide guidance on **how** to measure fair value under IFRS.

The IASB also hopes to increase convergence with US GAAP. The *Fair Value Measurement* project is included in the Memorandum of Understanding between the US Financial Accounting Standards Board (FASB) and the IASB (collectively, the Boards). In 2006, the FASB issued its fair value guidance while the IASB issued its exposure draft *Fair Value Measurement* in May 2009 (the May 2009 ED). Whereas the May 2009 ED was largely consistent with US GAAP, certain IASB proposals differed from US GAAP, where the IASB felt its changes would improve upon existing guidance.

In their comments on the May 2009 ED, many constituents stressed the importance of converged guidance for measuring fair value. In October 2009, the Boards agreed to develop common guidance on how to measure fair value and the related disclosure requirements, when IFRS or US GAAP (as applicable) requires or permits such measurement. As a result, the FASB issued an exposure draft of a proposed Accounting Standards Update (the Proposed Update) on 29 June 2010 which proposes changes to US GAAP that are intended to converge with IFRS. The IASB, meanwhile, decided to issue a limited re-exposure draft on the proposed disclosures related to measurement uncertainty through the release of the June 2010 ED.

The IASB has published a comprehensive project summary on *Fair Value Measurement*. The project summary provides background information, compares tentative decisions reached to date with proposals from the IASB's May 2009 ED as well as the FASB's recently released exposure draft and explains how the IASB plans to finalise its standard on fair value measurement.

Additional information about the FASB's Proposed Update to US GAAP can be found in our publication *Hot Topic: FASB proposes amendments to converge fair value guidance* available at www.ey.com/us

The IASB and the FASB together will consider the responses to the FASB's Proposed Update (due by 7 September 2010) before the IASB finalises its new standard.

What are the specific proposals in the IASB's June 2010 ED?

As background, the May 2009 ED proposed that an entity must disclose information that helps users of its financial statements assess the valuation techniques and inputs used to measure an asset or liability at fair value. In addition, the May 2009 ED proposed that an entity must provide a measurement uncertainty analysis for items measured at fair value in the statement of financial position that are classified within Level 3 of the fair value hierarchy.

Level 3 measurements in the fair value hierarchy are those that are based upon unobservable inputs for the asset or liability.

That is, the May 2009 ED proposed that if different unobservable inputs could have reasonably been used in place of one or more of the unobservable inputs actually used to estimate fair value, and those unobservable inputs would have changed fair value significantly, the entity would be required to state that fact. The entity would also be required to disclose the effect on fair value of using those different unobservable inputs, and how such effect was calculated. The Boards have tentatively confirmed these proposed requirements.

The June 2010 ED proposes that the effect of correlation between unobservable inputs must be considered in this analysis, if such correlation is relevant when estimating the effect of using those different unobservable inputs on the fair value measurement. That is, when a change in one unobservable input would affect one or more of the other unobservable inputs used, that correlation must be considered when determining the amount by which fair value might have changed, had a different unobservable input been used. For example, this might be the case when considering the

relationship between assumptions regarding prepayments and probabilities of default in the valuation of certain financial instruments.

However, the June 2010 ED also states that an entity is not required to consider remote scenarios. When assessing whether fair value would have changed significantly using different unobservable inputs, significance is assessed based on profit or loss, and total assets or total liabilities (or, when changes in fair value are recognised in other comprehensive income, significance is judged with respect to total equity).

The measurement uncertainty disclosures apply to all assets and liabilities measured at fair value in the statement of financial position that are Level 3 measurements, unless another IFRS specifically indicates the disclosure is not required. However, the IASB has not yet identified any assets or liabilities measured at fair value for which the measurement uncertainty disclosure would not be required.

How does the June 2010 ED compare to current IFRS and the May 2009 ED?

The measurement uncertainty disclosures in the June 2010 ED are very similar to the sensitivity disclosures currently required in IFRS 7 *Financial Instruments: Disclosures*. As a consequential amendment of the proposed new IFRS on *Fair Value Measurement*, the May 2009 ED proposes to delete the sensitivity disclosures in IFRS 7, because the same disclosures would be required by the new IFRS (that is, the disclosure requirement would be moved from IFRS 7 to the new IFRS). However, neither IFRS 7 nor the May 2009 ED requires an entity to consider the effect of interdependencies or correlation between unobservable inputs.

See our previous publication Supplement to *IFRS outlook* issue 43 for an understanding of the full proposed *Fair Value Measurement* standard (the May 2009 ED).

The Boards are now proposing to require these disclosures because certain respondents to the May 2009 ED noted that the proposed uncertainty disclosure would be more helpful if it required management to consider the effect of correlation between unobservable inputs. These respondents asserted that including the effect of correlation would help them to assess the extent to which using a different unobservable input would affect fair value.

While favoured by users and consistent with the recommendations from the IASB's Expert Advisory Panel, we expect that the proposals in the June 2010 ED may gain less support from preparers.

Is US GAAP converging with IFRS?

The FASB's Proposed Update includes amendments to clarify the existing principles in US GAAP to make the converged guidance more understandable to constituents (particularly to those constituents that would be applying this guidance for the first time). The main areas that the FASB proposes to add or clarify are:

- ▶ The concepts of 'highest and best use' and 'valuation premise' are relevant only for non-financial assets
- ▶ The criteria that must be met for an entity to use a 'portfolio approach' to measure the fair value of financial assets and liabilities
- ▶ The guidance for measuring the fair value of an instrument classified within shareholder's equity
- ▶ The circumstances in which a premium or discount may be applied, when measuring fair value, and the prohibition against applying a blockage factor
- ▶ The objective of a fair value measurement is to determine the price for a sale of the individual asset that is being measured (based on its unit of account), regardless of whether the asset or liability is used by itself or together with other assets
- ▶ The concepts related to determining the principal market
- ▶ The measurement uncertainty disclosures

Even though one of the objectives of this joint project is to converge US GAAP and IFRS on how to measure fair value when that measurement is required, certain differences between US GAAP and IFRS related to fair value will remain even after the Boards' respective standards are finalised.

For example, the IASB and FASB decided not to address the issue of recognising day one gains and losses, because they believe this is an issue of when and not how to measure fair value. It is hoped that this issue will be discussed as part of the Boards' projects on financial instruments.

The IASB also decided against providing a practical expedient to measure certain investments at net asset value (NAV). Given that IFRS does not currently have accounting requirements that are specific to investment companies and there are different practices for calculating NAV globally, the IASB determined it would be difficult to prescribe the circumstances under which such a practical expedient could be applied.

In addition, other differences remain between US GAAP and IFRS on when to use fair value.

When and how would the proposals become effective?

No effective date has yet been proposed, because the IASB is using the exposure draft process to solicit constituent feedback on the time and effort that would be needed to prepare and implement the new IFRS. The Boards indicated that they expect to issue final converged standards on fair value measurements in the first quarter of 2011.

The May 2009 ED proposed that the new standard would be applied prospectively, and that the new disclosures would be required only for periods beginning after the effective date. Comparative disclosures for periods prior to the effective date would therefore not be required.

What is the business impact?

For financial instruments, the proposed disclosure requirements in the May 2009 ED were generally consistent with the existing disclosure requirements of IFRS 7. However, the extension of the disclosure requirements to non-financial assets and liabilities measured at fair value in the statement of financial position based on Level 3 inputs (e.g., some investment property measured at fair value, some biological assets) might result in significant changes to processes and procedures for determining fair value, and providing the required disclosures.

In addition, the requirement to consider the correlation between unobservable inputs when assessing whether different unobservable inputs would have significantly changed fair value might require management to re-evaluate the processes and procedures for determining fair value, and the information that is accumulated for disclosures. If adopted as proposed, management will need to determine which unobservable inputs are correlated with each other, and the effect of that correlation on fair value.

Comments are due to the IASB by
7 September 2010

Ernst & Young
Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com

© 2010 EYGM Limited.
All Rights Reserved.

EYG no. AU0586

About Ernst & Young's International Financial Reporting Standards Group

The move to International Financial Reporting Standards (IFRS) is the single most important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every key decision you make, not just how you report it. We have developed the global resources – people and knowledge – to support our client teams. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young makes a difference.

In line with Ernst & Young's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.