Staff Paper

Project	**Fair value measurement**
Topic	**Comment letter summary**

Purpose of this paper

1. In June 2010, the FASB and the IASB published the following documents:

   (a) The FASB published an exposure draft of a proposed Accounting Standards Update (ASU) *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, which proposes amendments to Topic 820 *Fair Value Measurements and Disclosures* in the FASB *Accounting Standards Codification*™ (which codified FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* [SFAS 157]).

   (b) The IASB published an exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*. That exposure draft is a limited re-exposure of a proposed disclosure in the May 2009 exposure draft *Fair Value Measurement*.

2. Those exposure drafts were the result of the discussions held by the IASB and the FASB to develop common requirements for measuring fair value and disclosing information about fair value measurements. Although those exposure drafts were published separately by the FASB and the IASB, the boards will jointly consider the comments received, with the objective of issuing common finalised requirements in early 2011.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

3. This agenda paper summarises the comments received on *both* exposure drafts. The comment letters received by the FASB centred around the proposed measurement uncertainty analysis disclosure. In fact, several respondents addressed only that issue.

4. The comment period for both documents ended on 7th September 2010. We continue to receive responses.

5. In total, 161 responses have been received as of 9 September 2010 (86 in response to the FASB's exposure draft and 75 in response to the IASB's). If we identify additional issues in the letters received after the posting of this paper, we will provide an update to the boards at a later meeting.

6. Moreover, during re-deliberations we will include a more detailed analysis of each issue in the relevant agenda paper. Agenda Paper 9A (IASB) / 10 (FASB) sets out our general strategy for re-deliberations.

7. This paper does not provide a quantitative review of responses or attribute comments to individual respondents. Moreover, this paper does not address drafting suggestions received from respondents.

8. This paper contains the following appendices:

   (a) Appendix 1—information about the respondents (for comment letters received through 9 September 2010) to both the FASB's and the IASB's exposure drafts.

   (b) Appendix 2—questions in the FASB's exposure draft.

   (c) Appendix 3—questions in the IASB's exposure draft.

Key messages

9. Respondents overwhelmingly support the efforts of the boards to develop common fair value measurement and disclosure requirements for IFRSs and US GAAP and generally think the boards are on track to achieve that goal.

10. Many respondents think the proposed amendments to Topic 820 have the potential to change practice (eg the guidance on blockage factors, removing the highest and best use and valuation concepts for financial instruments) without further clarification. For example:
    (a) many respondents ask for guidance on measuring fair value when other standards do not clearly specify the unit of account; and
    (b) many respondents in the US who hold financial instruments are concerned about the interaction of the proposals in the FASB's exposure draft on accounting for financial instruments, which will increase the number of financial instruments measured at fair value, with the proposals for fair value measurement.
11. Many respondents have concerns about the proposed measurement uncertainty analysis disclosure. For example, many respondents are concerned about the practical implications (eg systems changes) necessary to develop the disclosure. Respondents also request further clarification about how to apply the proposed requirement, including how to determine the effect of correlation and when correlation is relevant.

Overview of comments received

Highest and best use and valuation premise concepts

12. Some respondents agree with the boards' conclusion that the highest and best use and valuation premise concepts are most relevant for non-financial assets and are not relevant for financial assets or for liabilities. They agree that the market price (fair value) of a financial instrument will not differ depending on why a market participant decides to buy it.
13. However, many respondents think this decision puts pressure on the unit of account when other standards do not clearly specify what the unit of account is for an asset or liability. For example, respondents think it is not clear in Topic 946 *Financial Services—Investment Companies* whether the unit of account for

an investment in debt and equity securities is the holding or each individual instrument that makes up the investment.[1]

14. In addition, some respondents are concerned that the lack of unit of account guidance for financial instruments could result in financial instruments always being measured on an instrument-by-instrument basis even when market participants would not transact at that level. The most commonly raised example of this is a pool of loans (eg mortgage loans) that will ultimately be sold as a group (eg securitised).

15. Some respondents suggest resolving this issue by incorporating the concept of 'value maximising behaviour' by market participants (this concept underlies the highest and best use and valuation concepts for non-financial assets). This could allow entities to measure the fair value of financial instruments in a way that maximises the value from a market participant perspective in the absence of clear unit of account guidance. These respondents suggest that when the unit of account is not clear, it would be appropriate for an entity to measure the fair value of a financial instrument at the level at which a transaction could actually take place.

16. Additionally, with respect to measuring the fair value of a non-financial asset that is used in combination with other assets or with other assets and liabilities as a group, some respondents ask for clarification about what is meant by 'complementary liabilities'.

Measuring the fair value of a reporting entity's own equity instruments

17. Respondents generally appreciate the additional guidance provided for measuring the fair value of an entity's own equity instruments (eg equity instruments issued as consideration in a business combination) that states that an entity is to estimate an exit price from the perspective of a market participant that holds the instrument as an asset.

[1] Paragraph 946-320-35-1 states that 'an investment company shall measure investments in debt and equity securities subsequently at fair value'.

18. Some respondents suggest clarifying that the guidance for measuring the fair value of a liability on the basis of the fair value of the corresponding asset is equally applicable when measuring the fair value of an entity's own equity instruments.

Measuring the fair value of a group of financial assets and financial liabilities

19. Respondents generally agree with the exception to fair value measurement requirements when an entity manages financial instruments on the basis of the entity's net exposure to market risk or credit risk. They expect that it will not change practice for measuring the fair value of financial instruments that are managed on the basis of the entity's net exposure to market risks or credit risk.

20. Some respondents ask for clarification about the following aspects of the proposed guidance:

    (a) what is meant by market risks being 'substantially the same';

    (b) what is meant by 'managing' financial instruments on the basis of the entity's net exposure to market or credit risk; and

    (c) whether the guidance would apply only to financial instruments recognised at fair value in the statement of financial position or if it also would apply to financial instruments for which fair value is disclosed.

Application of premiums and discounts

21. Respondents generally support the inclusion of additional guidance on the meaning of a blockage factor and distinguishing it from other premiums and discounts (eg a control premium) in a fair value measurement.

22. Some respondents disagree with the prohibition of blockage factors, even in Level 1 of the fair value hierarchy, because they note that if a large holding of a financial instrument were sold it could not be disposed of at a value that equals the quoted price multiplied by quantity held when that quoted price is based on a significantly smaller lot size. Having said that, many of those respondents

understand the boards' rationale for prohibiting the application of blockage factors in Level 1.

23. Many respondents would like clarification about the following:

(a) how to apply the proposed guidance when the unit of account is not clearly specified in another standard (see the discussion in paragraphs 13–15 above);

(b) why an entity can apply a control premium but not a blockage factor even though both depend on the size of a holding;

(c) distinguishing between blockage factors and adjustments for liquidity and concentration risk; and

(d) whether it is appropriate to recognise a day 1 gain when a blockage factor was incurred in the transaction to buy an instrument but cannot be applied in the fair value measurement for accounting purposes.

Measurement uncertainty analysis disclosure

24. This section contains an overview of the comments received. We will address the detailed comments received in a later agenda paper.

25. The staff think it is important to acknowledge the different perspectives of the respondents before considering the specific comments received on the proposed measurement uncertainty analysis disclosure.

Perspectives of IFRS and FASB constituents

26. A similar disclosure is currently required in IFRS 7 *Financial Instruments: Disclosures* and has been in international standards since 2003 (it was added to the previous IAS 32 *Financial Instruments: Disclosure and Presentation* as part of the 2003 Improvements Project).

27. As a result, IFRS constituents are mainly concerned about scope (eg limiting it to financial instruments) and, although many support the idea of including the effect of correlation in concept, have practical questions about how to apply the

proposed new requirement to include the effect of correlation in the measurement uncertainty analysis.

28. Such a disclosure is not currently required in US GAAP. Respondents to the FASB's exposure draft are overwhelmingly opposed to the proposed disclosure (in fact, most of the comments received focus only on this issue). Many FASB constituents question the objective of the disclosure and whether it would (a) be meaningful for users of financial statements, (b) be operational for preparers and (c) be auditable by auditors.

Objective of the disclosure

29. Some respondents think that the objective of the disclosure is unclear. For example, they question whether the purpose is:

    (a) to assess management's judgement in determining Level 3 fair value measurements;

    (b) to assess the sensitivity of Level 3 fair value measurements to changes in the most significant unobservable inputs;

    (c) to provide a range of reasonable exit prices that could have resulted from using alternative assumptions; or

    (d) something else.

30. Without a clear objective, some respondents think it will be difficult to implement the disclosure and to achieve comparability across reporting entities and over time.

Specific comments received

31. Some respondents support the idea of including the effect of correlation in concept, but have concerns about the practical implications of doing so. In addition to concerns about cost-benefit (eg due to systems changes and additional resource and audit costs), respondents raise the following issues:

    (a) there are concerns that the disclosure undermines the legitimacy of Level 3 fair value measurements;

(b) there is a lack of guidance on the level at which the effect of correlation should be determined (eg at the individual asset level or across a group of assets) and questions regarding the meaningfulness of the analysis at aggregated levels;

(c) there is a lack of guidance on how to select assumptions that could have reasonably been used in the circumstances. They are concerned that in the absence of such guidance, there will be diversity in practice, reducing comparability;

(d) there are concerns about limiting ‘the effect of correlation’ to unobservable inputs if there is a relationship between unobservable inputs and any of the observable inputs;

(e) there are questions about how the disclosure would be prepared when a fair value measurement relies on broker quotes and pricing data from third-party pricing services;

(f) there are concerns that the analysis required for financial instruments that are categorised as Level 3 in the fair value hierarchy would be misleading with respect to the entity’s actual risk exposure when those risks are hedged by other financial instruments that are categorised as Levels 1 or 2 in the fair value hierarchy and do not require or contribute to this analysis; and

(g) there are concerns about the scope of the proposed disclosure, such as:

    (i) investments in investment company entities when the entity uses the net asset value practical expedient (ie ASU 2009-12 *Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)*);

    (ii) unquoted equity investments that would not be given a scope exception until the ASU on financial instruments is finalised; and

    (iii) consolidated non-controlling interests (eg collateralised loan obligations).

32. Furthermore, many respondents are concerned that the boards meant ‘correlation’ in the statistical sense (given that correlation is a commonly used term in quantitative analysis) and wonder whether the correlations themselves are unobservable inputs for which the measurement uncertainty analysis should be done. They also wonder whether pricing models will need to be changed to accommodate a ‘correlation’ input. (It is worth noting that the bases for conclusions for the exposure drafts state that correlation means that entities need to determine which inputs are related and which inputs would need to be changed in combination with one another to arrive at a fair value measurement under an alternative reasonable scenario.)

Alternative disclosure suggestions

33. Some respondents suggested alternative disclosures such as:

    (a) an analysis that does not take into account the effect of inter-relationships between inputs;

    (b) a qualitative disclosure about the controls used for measuring fair value and the aggregate risks and exposures to key unobservable inputs;

    (c) a qualitative disclosure about market conditions at the measurement date that might negatively influence the fair value of the asset or liability;

    (d) a disclosure specifying a set percentage change in key unobservable inputs (eg a +/- X% change for each variable);

    (e) a disclosure of the percentage of fair value measurements that use any unobservable inputs; or

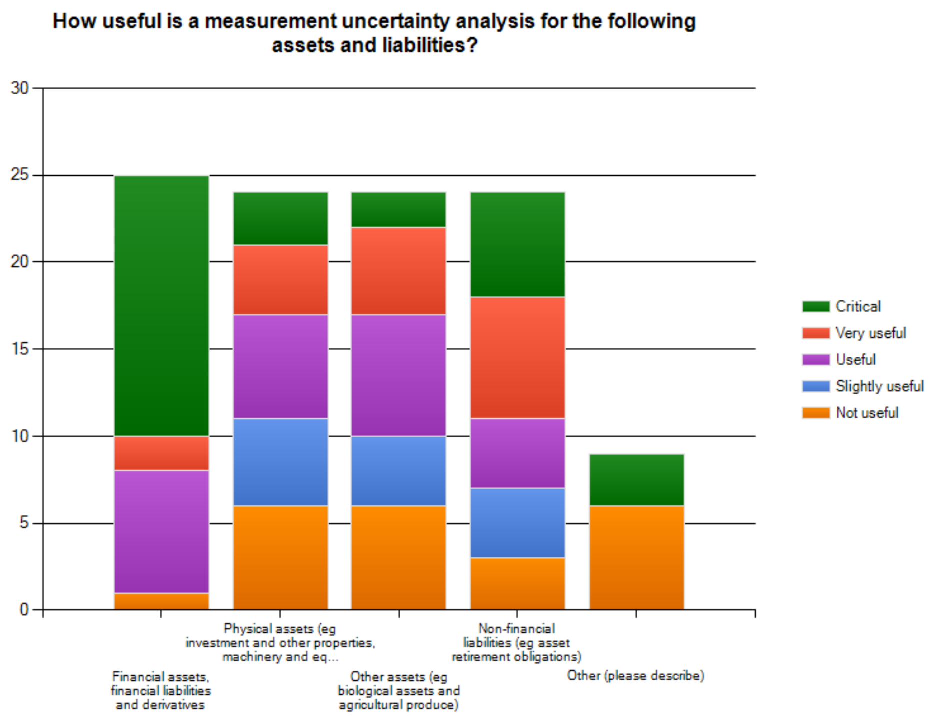
    (f) a quantitative disclosure of unobservable inputs (Topic 820 currently requires a disclosure of ‘a description of the inputs used in the fair value measurement’; IFRS 7 currently requires disclosure of ‘the assumptions applied in determining fair values’ when using a valuation technique).

Results of user questionnaire

34. The IASB and the FASB posted a joint user questionnaire in July 2010 asking users of financial statements to give feedback on the proposed disclosure. The boards received a total of 32 responses, of which at least 17 were analysts and other financial statement users, from respondents in the US, Europe, South America, South Africa and Asia. (Not all respondents answered all questions in the questionnaire and not all who responded to the questionnaire provided information about themselves.)

35. Most of the respondents indicated that they use the information provided today for financial instruments. Of those who use this information, most use it as a 'worst-case scenario' by using the lower limit of the fair value in their analyses. Some indicated that they use it to assess management's judgement, to make an independent assessment of value or to understand the risks associated with the measurement.

36. The chart below summarises the responses about the importance of a measurement uncertainty analysis disclosure by type of asset or liability.



37. Most respondents indicated that they think companies should have to take into account relationships between assumptions when preparing the disclosure (ie that they take into account the effect of correlation between inputs). In addition, some stated that if companies provided the assumptions used, users would be able to make their own assessment of the inter-relationships and whether management was using conservative or aggressive assumptions.

38. Most respondents indicated that aggregation by ‘class’ would be sufficient, although they prefer more disaggregation to less disaggregation.

Transition requirements (FASB only)

39. Very few respondents commented on the proposed transition requirements. Of those who did comment, some agree with the proposal to require limited retrospective transition for the proposed amendments. Others suggest requiring prospective transition only, consistent with other amendments to Topic 820 made in the past.

Time needed for implementation (FASB only)

40. Most respondents think the proposed amendments, with the exception of the measurement uncertainty analysis disclosure, are not significant and would take little time to implement (a few respondents suggested six months).

41. Some respondents think the measurement uncertainty analyse disclosure will take a significant amount of time to implement because they will need to accumulate and analyse the data required to be disclosed. This is of particular concern for entities that do not currently use this type of analysis and, as noted above, will require systems changes.

42. Respondents suggest that the effective date for the measurement uncertainty analysis disclosure, if adopted, should coincide with the effective date of the final ASU on financial instruments for the following reasons:

    (a) the proposed ASU on financial instruments would require a significant amount of additional fair value measurements and they think it would be helpful to put the systems in place to deal with the requirements of both standards at the same time; and

(b) the proposal in the ASU on financial instruments to exclude unquoted equity instruments from the scope of the measurement uncertainty analysis disclosure would not be effective until after the financial instruments ASU is finalised, resulting in a requirement to prepare the disclosure for such instruments in the meantime.

Application by non-public (private and not-for-profit) entities (FASB only)

43. Many respondents think the proposed amendments to Topic 820 apply equally to public and non-public entities given that non-public entities are currently applying Topic 820 and most of the proposed amendments are not significant changes.

44. However, some respondents suggest that the measurement uncertainty analysis disclosure not be required for non-public entities given the resources necessary to prepare such a disclosure, or that it has a later effective date.

Other comments received

45. Some respondents included comments about other aspects of fair value measurement that were not covered by the 'Questions for respondents'.

General comments about fair value measurement

46. Some respondents had general comments unrelated to the proposed amendments, for example:

(a) concerns about the measurement objective (such as defining fair value as an exit price, using a transfer notion for liabilities and having a market participant view); and

(b) concerns about specific guidance (such as the requirement to reflect changes in an entity's own credit risk in a fair value measurement).

47. Some respondents ask the boards to converge the requirements for recognising day 1 gains or losses and using the net asset value practical expedient as soon as is practicable.

Requests for additional guidance

48. Some respondents asked for additional guidance on the following:

    (a) how to quantify liquidity risk when measuring fair value in an inactive market;

    (b) the presentation of third party credit enhancements if the credit enhancement is not included in the fair value of the liability;

    (c) the frequency of calibration after initial recognition; and

    (d) how much effort entities should undertake to determine whether the current use of their assets is also the highest and best use of those assets.

Comments about disclosures

49. Some respondents raised the following about the disclosures:

    (a) they disagree with the proposal to require an entity to disclose <u>all</u> transfers between Level 1 and Level 2 of the fair value hierarchy, rather than all <u>significant</u> transfers. They think it will be burdensome for entities to monitor insignificant transfer activity with little or no benefit to users of financial statements;

    (b) they think the proposal to require disclosure by level in the hierarchy for assets and liabilities (for US GAAP, financial instruments) not measured at fair value in the statement of financial position but for which fair value is disclosed does not provide users with useful information;

    (c) they wonder whether the proposed disclosures are also required for items measured at fair value less costs to sell;

(d) they think the proposal to disclose when an entity uses an asset in a way that differs from its highest and best use is only meaningful for specific assets (eg real estate and defensive assets); and

(e) questions about the frequency of the disclosures (ie whether they are for annual periods only or for both interim and annual periods).

Appendix 1: Respondent information

FASB

Respondent type	Africa	Asia-Pacific	Europe	International	North America	South America	Grand Total
Academic					2		2
Accounting Firm				6	1		7
Consultant: Valuation				1			1
Individual					7		7
Other			1				1
Other: Not-for-profit/public sector				2			2
Preparer (representative body): Banking			1	2	3		6
Preparer (representative body): Financial Services				1			1
Preparer (representative body): Insurance					2		2
Preparer (representative body): Investment Company				1	3		4
Preparer (representative body): Power & Utility					1		1
Preparer: Banking			3	2	11		16
Preparer: Financial Services					2		2
Preparer: Healthcare					2		2
Preparer: Insurance			1		4		5
Preparer: Investment Company					10		10
Preparer: Manufacturing					2		2
Preparer: Power & Utility					4		4
Preparer: Telecommunications					1		1
Professional body: Accounting					7		7
Standard setter: Accounting			1		1		2
Standard setter: Valuation				1			1
Grand Total	**0**	**0**	**7**	**16**	**63**	**0**	**86**

IASB

Respondent Type	Africa	Asia-Pacific	Europe	International	North America	South America	Grand Total
Academic						2	2
Accounting Firm			1	4			5
Consultant (representative body):Valuation				1			1
Consultant: Other		1			1		2
Consultant: Valuation				1			1
Government		2					2
Individual		1	1				2
Other			1				1
Other: Not-for-profit/public sector			1	1	1		3
Preparer (representative body): Banking		1	6	2	2		11
Preparer (representative body): Insurance		1	1		1		3
Preparer (representative body): Other			1	1			2
Preparer: Automotive		1					1
Preparer: Banking		1	6	1			8
Preparer: Consumer Products	1						1
Preparer: Healthcare			1				1
Pricing service			1				1
Professional body: Accounting		3	4				7
Regulator (representative body): Banking			1				1
Regulator (representative body): Securities				1			1
Regulator: Banking				1			1
Regulator: Securities		2					2
Standard setter: Accounting	1	5	6		1	1	14
Standard setter: Valuation				2			2
Grand Total	**2**	**18**	**31**	**15**	**6**	**3**	**75**

Appendix 2: Questions in the FASB's exposure draft

Question 1: This Exposure Draft represents the Board's commitment toward developing common fair value measurement guidance with the IASB. Do you think the proposed amendments:

a. Would improve the understandability of the fair value measurement guidance in U.S. GAAP? If not, why not?

b. Would result in any unintended consequences on the application of the proposed amendments? If so, please describe those consequences.

Question 2: The Board has decided to specify that the concepts of highest and best use and valuation premise are only to be applied when measuring the fair value of nonfinancial assets. Are there situations in which those concepts could be applied to financial assets or to liabilities? If so, please describe those situations.

Question 3: Do you agree with the proposed guidance for measuring the fair value of an instrument classified in shareholders' equity? Why or why not?

Question 4: The Board has decided to permit an exception to fair value measurement requirements for measuring the fair value of a group of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to a particular market risk (or risks) (that is, interest rate risk, currency risk, or other price risk) or to the credit risk of a particular counterparty.

a. Do you think that proposal is appropriate? If not, why not?

b. Do you believe that the application of the proposed guidance would change the fair value measurements of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to those risks? If so, please describe how the proposed guidance would affect current practice.

Question 5: The Board has decided to clarify the meaning of a blockage factor and to prohibit the use of a blockage factor when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). Do you think that proposal is appropriate? If not, why not?

Question 6: The Board has decided to specify that other premiums and discounts (for example, a control premium or a noncontrolling interest discount) should be taken into account in fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy when market participants would take into account those premiums or discounts when pricing an asset or a liability consistent with the unit of account for that asset or liability.

a. Do you think that proposal is appropriate? If not, why not?

b. When the unit of account for a particular asset or liability is not clearly specified in another Topic, how would you apply that proposed guidance in practice? Please describe the circumstances (that is, the asset or liability and the relevant Topic) for which the unit of account is not clear.

Question 7: The Board has decided to require a reporting entity to disclose a measurement uncertainty analysis that takes into account the effect of correlation between unobservable inputs for recurring fair value measurements categorized 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, the Board has decided in its project on the accounting for financial instruments that a measurement uncertainty analysis disclosure would not be required for investments in unquoted equity instruments). Do you think that proposal is appropriate? If not, why not?

Question 8: Are there alternative disclosures to the proposed measurement uncertainty analysis that you believe might provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorized 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.

Question 9: The Board has decided to require limited retrospective transition. Do you think that proposal is appropriate? If not, why not?

Question 10: There is no link to the transition guidance for the proposed amendments that the Board believes would not change practice. Are there any proposed amendments that are not linked to the transition guidance that you think should be linked? If so, please identify those proposed amendments and why you think they should be linked to the transition guidance.

Question 11: The amendments in this proposed Update would apply to public and nonpublic entities (that is, private companies and not-for-profit organizations). Should any of the proposed amendments be different for nonpublic entities? If so, please identify those proposed amendments and describe how and why you think they should be different.

Question 12: How much time do you think constituents would need to prepare for and implement the amendments in this proposed Update?

Appendix 3: Questions in the IASB's exposure draft

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?

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.