

## Investor Perspectives

### Patrick Finnegan: Some things we are certain about, other things we just don't know



#### A proposal to analyse uncertainty

Many fair value measurements use unobservable inputs, which inherently leads to uncertainty in such measurements. In June, we published the exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*, which proposes a disclosure to give investors information about the effects of that uncertainty.

#### What is required today?

Companies applying IFRSs are currently required to disclose information about the sensitivities of fair value measurements to the main valuation assumptions for **financial instruments** measured at fair value. This disclosure is not currently required for companies applying US GAAP.

The disclosure provided today is intended to provide information about the potential measurement uncertainty inherent in those fair value measurements that have the greatest level of subjectivity (Level 3 fair value measurements that are determined using models with unobservable data). It reflects the effect upon the fair value of changing each main assumption **in isolation**. It does not reflect any relationships that may exist between assumptions.

#### What are we proposing?

The IASB and the FASB are proposing that companies must disclose information about the sensitivities of fair value measurements to the main valuation assumptions for **all** Level 3 fair value measurements (not just for

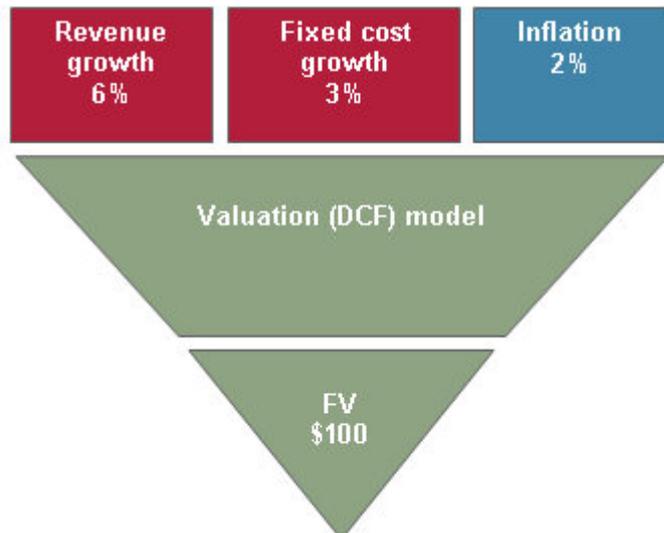
financial instruments). The boards' proposals refer to this disclosure as a **measurement uncertainty analysis**.

The proposal would require companies to take into account the relationship between assumptions, if there is one.

To illustrate the proposed disclosure requirement, let's examine an example:

Company A has an investment in the unquoted shares of Company B. Assume that Company A measures the fair value of the investment using a discounted cash flow model with three main valuation assumptions:

- revenue growth (an unobservable assumption based on Company B's historical growth rate and industry expectations);
- fixed cost growth (an unobservable assumption based on Company B's historical cost growth rate); and
- inflation (an observable assumption based on published economic data).



Company A determines that the fair value of the equity investment is \$100 and presents this amount in the statement of financial position.

In addition, the company discloses information in the notes to its financial statements about the main valuation assumptions. For example, Company A would show that it concluded on a revenue growth rate of 6% and a fixed

cost growth rate of 3%, because those were determined to be the most reasonable in the circumstances.

However, those are unobservable inputs, and are likely to have been taken from a range of reasonable assumptions. Perhaps a revenue growth rate of 4% and a fixed cost growth rate of 2% also would have been reasonable. If so, Company A would disclose the effect of using the lower growth rates. Today, the disclosure would reflect the effect on the fair value of changing revenue growth **in isolation**, and fixed cost growth **in isolation**, even though those assumptions are related. Our proposal would require Company A to consider the relationship between revenue growth and fixed cost growth. In other words, **the proposed disclosure would give investors and creditors an idea of what the fair value would have been in an alternative scenario.**

In the proposed disclosure, Company A would also be required to explain how it calculated the revised fair value, perhaps by comparing the assumptions used to arrive at the fair value presented in the statement of financial position with the assumptions used in the measurement uncertainty analysis. In addition, it would need to provide information about the models and assumptions that were used in the fair value measurement.

### **What do you think?**

We are always trying to balance the information needs of investors and creditors with the costs incurred by companies to meet those needs. Would you find this new disclosure useful, and if so, how would you use it?

Please take a few minutes to complete our questionnaire designed to solicit feedback from investors and creditors. Please also feel free to send me your comments on this article via the link below. I'll make sure that the project team and the Board are made aware of your views.

**Patrick Finnegan** is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.