



**INTERNATIONAL VALUATION STANDARDS COUNCIL**

**DISCUSSION PAPER**

# Valuation Uncertainty

*Comments to be received by 24 December 2010*

September 2010

## Discussion Paper

# Valuation Uncertainty

*published September 2010*

This Discussion Paper is published by the International Valuation Standards Board which is the independent standard-setting body of the International Valuation Standards Council.

Comments on this Discussion Paper are invited before 24 December 2010. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to [CommentLetters@ivsc.org](mailto:CommentLetters@ivsc.org) or by post to the **International Valuation Standards Board, 41 Moorgate, LONDON EC2R 6PP, United Kingdom.**

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## Note for Respondents

Responses are particularly invited to the following questions. Not all questions need to be answered but please indicate the question to which any answer relates:

- 1 Do you agree that it is only when material, or abnormal, uncertainty attaches to a valuation on a specific time or date that that specific disclosure is necessary when the valuation is reported? If not please explain why you consider that an uncertainty statement should be provided in all cases.
- 2 Do you believe that the Board has identified all major sources and types of material valuation uncertainty? If not please identify what additional causes of uncertainty exist and how often you encounter these in practice.
- 3 Do you agree with the Board's conclusion that an explanation of any abnormal uncertainty identified and an explanation of the impact this has on the valuation (a qualitative statement) is more helpful to users in understanding the valuation than a purely numeric expression of the range of possible values created by the uncertainty (a quantitative statement)?
- 4 Do you think the IVSB should include an explicit requirement in the proposed IVS 105, Valuation Reporting, to disclose any material uncertainty or is the principle that requires valuation reports not to be ambiguous or misleading sufficient?
- 5 Do you consider that there are cases where a qualitative statement of the causes and impact of uncertainty on the valuation is inadequate and should be either augmented or replaced by a quantitative statement? If so please
  - a. state the circumstances and assets classes where you believe that quantitative statements are more helpful to users and,
  - b. provide a brief explanation or example of the type of quantitative statement that you believe would be useful.
- 6 Do you consider that it would be helpful if IVSC developed guidance on methods for making a quantitative disclosure of uncertainty under specific circumstances? If so please indicate the circumstances and any methods that you either use or encounter in your market.

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## Introduction

- 1 The International Valuation Standards Board (“the Board”) has issued this discussion paper in the light of growing calls from financial regulators for the better identification and communication of uncertainty in valuations. This paper summarises the Board’s preliminary views on the nature and causes of valuation uncertainty and on how this should be communicated to valuation users. The Board will consider responses to this paper in deciding whether amendments are required to the proposed new International Valuation Standards<sup>1</sup> and whether a project should be undertaken to consider the development of technical guidance on possible methods for estimating a quantitative measure of uncertainty.
- 2 A lack of adequate identification and disclosure of material uncertainty has been identified by a number of global institutions as a contributory factor to the global financial crisis of 2007 and 2008.
  - 2.1 In 2008, the Financial Stability Forum (FSF)<sup>2</sup> published an analysis of the causes and weaknesses that had produced the turmoil in financial markets.<sup>3</sup> One of the five recommendations of the FSF was to enhance transparency in valuations. The focus was on strengthening disclosure requirements, improving and converging financial reporting standards for off-balance sheet vehicles and developing guidance on valuations when markets are no longer active. The paper noted that valuation methods “result in an inevitable measure of uncertainty attaching to the point estimates of valuation. Finding ways to highlight such uncertainty is important to avoid giving management and market participants a false impression of precision...”.
  - 2.2 In April 2009, the *G20 Declaration on Strengthening the Financial System* called for improved standards for valuation uncertainty in the context of fair value accounting.
  - 2.3 The Basel Committee for banking supervision issued its paper *Supervisory Guidance for Assessing Banks’ Financial Instrument Fair Value Practice* in April 2009. This emphasised the critical importance of robust risk management and control processes around the measurement of fair values and their reliability. The paper recognised the importance of “articulation and communication of valuation uncertainty both within a bank and to external stakeholders”.

<sup>1</sup> Proposed New International Valuation Standards, Exposure Draft June 2010

<sup>2</sup> Now the Financial Stability Board

<sup>3</sup> Report of the Financial Stability forum on Enhancing Market and Institutional Resilience. 7 April 2008.

- 2.4 In August 2010 the Financial Services Authority for the United Kingdom issued a paper “The prudential regime for trading activities”<sup>4</sup> which examines deficiencies in current regimes for reflecting risks in the trading activities of banks in the capital adequacy requirements under the emerging revisions to Basel Accord. Among its recommendations is the specific assessment of valuation uncertainty.
- 3 The International Accounting Standards Board (IASB) has also responded by requiring additional valuation disclosures in the International Financial Reporting Standards (IFRSs).

### **The Nature of Valuation Uncertainty**

- 4 A valuation is not a fact; it is an estimate of the most probable of a range of possible outcomes based on the assumptions made in the valuation process. Market valuations are estimates of the most probable price that would be paid in a transaction on the valuation date. However, in most markets actual prices are subject to fluctuations caused by market imperfections, differences in the characteristics of the asset or differences in the objectives, knowledge or motivation of the parties. Consequently, an element of uncertainty is inherent in all market valuations as there is not a single price with which the valuation can be compared.
- 5 In some cases the degree of uncertainty is clearly negligible, for example where the valuation is made by reference to current prices for identical assets in the same market as in the case of publicly listed and frequently traded securities. In others, uncertainty may be identifiable but it is immaterial in the context of the market for the particular asset or the valuation assignment because it falls within the range that would be expected, and accepted, by most market participants. This may be thought of as “normal” uncertainty. The Board does not consider that this is something that should be either a source of concern to users or that needs specific disclosure by the valuer. However, there are cases where the degree of uncertainty in a valuation falls outside any range that might normally be expected and accepted. It is this abnormal or material uncertainty that should be both recognised by valuers and properly communicated to valuation users.

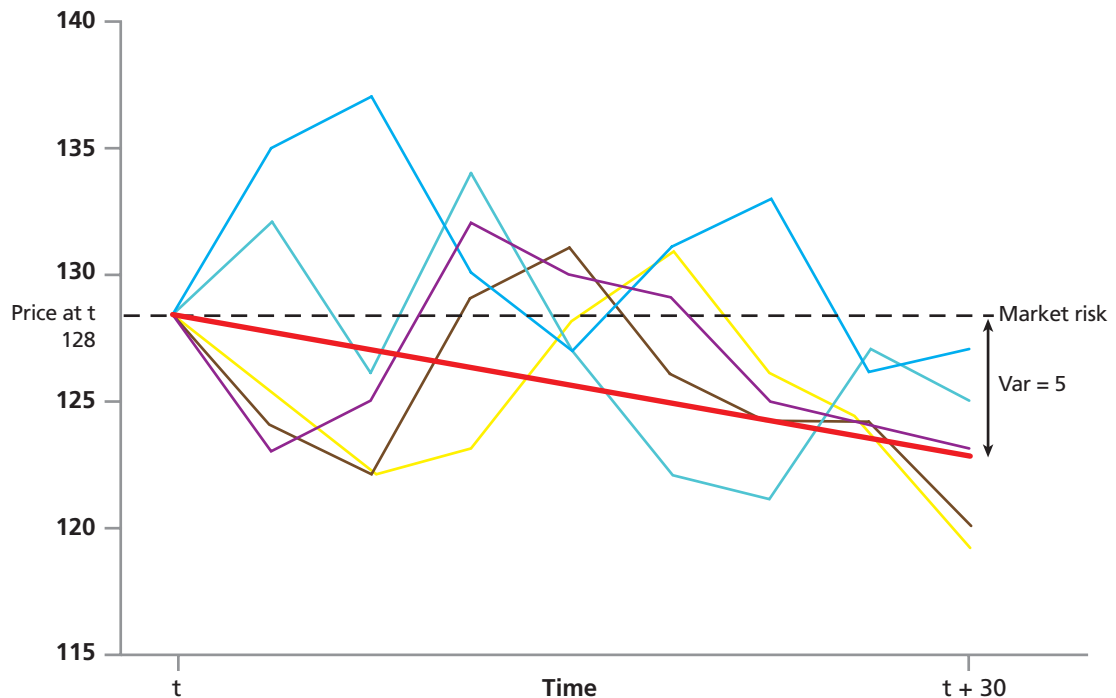
### **Valuation Uncertainty versus Market Risk**

- 6 Valuation uncertainty should not be confused with market risk. In the context of market value<sup>5</sup>, valuation uncertainty relates to the probability that the valuation estimate would differ from the price in an actual transaction on the same terms on the valuation date. In contrast, market risk is the loss an asset can face in a given interval of time due to changes in market conditions over that period.

<sup>4</sup> FSA Discussion paper 10/4

<sup>5</sup> See market value definition in IVS 2007 IVS 1 and in Exposure Draft of New IVS issued June 2010, IVS 103.

- 7 This difference can be illustrated by the following example involving publicly traded blue chip stock listed on more than one exchange. It can be observed that the market price of the stock fluctuates over time. The market risk for a shareholder for one month is the maximum expected loss due to changes in market price of the stock during that month. Those fluctuations may be due to changes in the macro economic outlook or due to successive buyers and sellers having different views of the price of the stock on different dates. Market risk is also known as value at risk. However, because blue chip shares are actively traded there would be hardly any valuation uncertainty on a given valuation date. The stock is quoted on public exchanges and traded in high volumes on a daily basis. The risk of the actual exchange price significantly differing from a near contemporaneous quotation or valuation is close to zero.
- 8 The following graph illustrates the difference between valuation uncertainty and market risk.



*The red line shows the one month market risk associated with a blue chip stock, based on the mean of observed price fluctuations in the stock over previous thirty day periods represented by the other lines. There is negligible uncertainty attaching to a valuation of 128 at time "t" because all contemporaneous transactions at that time are either at this price or very close to it, but the value at risk over the next 30 days is about 5.*

## Liquidity and Market Activity

- 9 Valuation uncertainty generally increases due to a lack of market activity, a lack of liquidity or a combination of both. Although an active market is normally liquid, liquidity does not depend on activity. The market for Rembrandt's paintings is inactive since firstly there are relatively few in number and secondly they are only very occasionally sold. However, there is also always a high demand for any of his paintings that may come to the market, thus meaning that the liquidity of his work is high.
- 10 Valuation uncertainty arises with Rembrandt's paintings due to the uniqueness of each painting and the fact that the last sale of another Rembrandt may have been long before the valuation date. Although there may be many potential buyers, their motivations and resulting price expectations will vary widely. So in spite of comparatively high liquidity, the relatively low activity creates valuation uncertainty.
- 11 The effect of either reduced liquidity or activity is to reduce the amount of data available to provide empirical support for valuations. This in turn increases the reliance on the extrapolation of evidence from transactions involving similar rather than identical assets or of historic transactions involving identical assets. In such cases the degree of judgement required by the valuer increases thus increasing the level of uncertainty in the valuation estimate.

## Sources of Valuation Uncertainty

- 12 The Board has identified five principal sources of valuation uncertainty:
  - 12.1 Status of valuer: as discussed earlier, material uncertainty is more likely to arise where the valuation estimate relies extensively on judgement. The accuracy and relevance of those judgements is dependent on the skill and experience of the person making them. The confidence that can be placed in those judgements by users is also dependent on whether that person is making them from a position of independence. Material uncertainty can arise if the valuer is not sufficiently experienced or is in a position which could give rise to a suspicion of bias.
  - 12.2 Scope of Work: the certainty attaching to any valuation will depend upon both the nature of the valuation task and the degree of investigation undertaken as part of the valuation assignment. If the valuation date is in the recent past, the valuation estimate is likely to be more certain than one made either at the date of reporting or as of a future date because hindsight assists in verifying the validity of the inputs. The degree of investigation undertaken also has an impact, as clearly a valuation estimate made after full investigation and verification of inputs is more certain than one based upon unverified assumptions. Where investigations are curtailed below the level that would be normally expected in a valuation of a particular asset for a particular purpose, then material uncertainty is likely to arise.

- 12.3 Market uncertainty:** this arises where there is disruption of a market caused by unforeseen events such as financial, macroeconomic and political crises. These can all have a dramatic effect on markets. This could be manifested by panic buying or selling or in other cases by disinclination to trade until the longer term effects of the event on the market can be seen. In any case market stress will generally mean that the market data will be incomplete or even contradictory, thus generating uncertainty. The impact on the markets of events such as the terrorist attacks of September 11th 2001 or the Lehman Brothers insolvency in 2008 are two examples of macro political events causing material uncertainty. Market uncertainty can also arise due to micro economic events. For example, an anticipated change in the law or impending judicial decision may result in either a decline or suspension of activity in the market for a particular type of asset or, conversely, similar circumstances may result in excessive speculative activity.
- 12.4 Model uncertainty:** this arises from characteristics of either the valuation model or method used. For certain asset types, more than one method may be customarily used to estimate value. However, those models may not always produce the same outcome and therefore the selection of the most appropriate method may of itself be a source of uncertainty. In certain valuation models the outcome may be disproportionately sensitive to small variations in the input data, for example due to gearing effects in the model.
- 12.5 Input uncertainty:** this arises from the degree of veracity that can be attached to the data inputs used in the valuation and their impact on the outcome. Examples of input uncertainty include:
- Where the input is taken from consensus data or a composite of market data, there will normally be a range between which the market value can fluctuate.
  - Where inputs are based on historic data, the assumptions or methods used to adjust the data to market conditions at the valuation date can be a source of uncertainty.
  - Where inputs are estimated or extrapolated from directly observable prices, uncertainty can result from the adjustments made.
- 13** It is important to note that the causes of valuation uncertainty discussed above are not mutually exclusive. For example, there is a link between model and input uncertainty as different models may use different inputs that are subject to different degrees of uncertainty. Also, an asset may be affected simultaneously by market, input and model uncertainty.
- 14** Interdependence and correlation between uncertainty factors are therefore likely to exist and account should be taken of this as part of the valuation process. The question of measurement and reporting of uncertainty is addressed in more detail in the following sections.



## Measuring Uncertainty

- 15 In discussing the quantitative and qualitative aspects of uncertainty, the Basel Committee noted:<sup>6</sup>

*“Supervisors expect bank valuation and risk measurement systems to systematically recognise and account for valuation uncertainty. In particular, valuation processes and methodologies should produce an explicit assessment of uncertainty related to the assignment of value for all instruments or portfolios. When appropriate this may simply be a statement that uncertainty for a particular set of exposures is very small. While qualitative assessments are a useful starting point, it is desirable that banks develop methodologies that provide, to the extent possible, quantitative assessments. These methodologies may gauge the sensitivity of value to the use of alternative models and modelling assumptions (when applicable), to the use of alternative values for key input parameters to the pricing process, and to alternative scenarios to the presumed availability of counterparties.”*

- 16 The FSA discussion<sup>7</sup> paper recognises that valuations always contain some uncertainty, which means that there is a risk that the price realised on a sale of a position will differ from the valuation, even when the risk remains unchanged. It goes on to advocate that the solvency risks arising from valuation uncertainty should be captured by introducing a capital requirement based on a calculation of uncertainty reflecting both “methodological and supply/demand uncertainty”. “Methodological uncertainty” is described in the paper in similar terms to model uncertainty in this paper. The FSA relates “supply/demand uncertainty” specifically to market liquidity. Although the Board agrees that lower levels of market activity increase valuation uncertainty, as discussed in paragraphs 9 -11, liquidity and market activity are not necessarily synonymous.
- 17 Although the banking regulators have a clear expectation that there is benefit in quantitative assessments of uncertainty in the valuation of financial instruments, this gives rise to two questions. Firstly, is it possible to identify methods of calculation that are sufficiently robust to provide credible and operationally useful quantitative measures of uncertainty? Secondly, would such a measure be useful to valuation users generally outside the specific objective of providing an input that can be used to bring consistency to the establishment of prudent capital requirements in the banking sector?
- 18 Material valuation uncertainty often arises because of a lack of empirical data inputs to support the valuation. This may require the use of estimated inputs, or where an estimate cannot be reasonably made, an alternative valuation method may be used either alone or as a cross check on the primary method. However, where inputs cannot be quantified with the degree of precision, or certainty, that is normal for that asset and market, it follows that attempting to provide a quantitative measure of the resulting uncertainty is itself an imprecise exercise. Indeed seeking precision in the measurement of something that is inherently imprecise is a false science and could give users inappropriate assurance which would be more misleading than making no disclosure at all.

<sup>6</sup> Op cit

<sup>7</sup> Op cit

19 The Board considers that there are some basic principles that need to be considered when deciding whether either a quantitative measure or a particular technique is appropriate:

- A purely numeric illustration will only confirm uncertainty, not explain it. There is no useful purpose served by providing such a quantitative expression of uncertainty if this will not result in a better understanding of the valuation by the user. Accordingly, it will be rare that a quantitative measure will be sufficient in isolation, but will need a suitable supporting explanation.
- Quantifying valuation uncertainty is not simply identifying the worst case scenario. The objective is not to stress test a valuation to an extreme worst case. Any test of valuation uncertainty should address the impact on the reported value of reasonable and likely alternative assumptions. Therefore when choosing alternative assumptions to measure uncertainty, selection needs to be made among possibilities that are not located in the tail of the distributions (where events are very unlikely to happen) but rather in their central areas (where events are likely to occur).
- Valuation uncertainty measurement is not forward looking. The objective of any uncertainty analysis is not to provide a forecast of possible fluctuations in the reported value at future dates but to provide information about the variability of fair value measurement at the specific valuation date. Possible future fluctuations are due to market risk.
- When quantifying the impact of uncertainty, the interdependence or correlation between significant inputs needs to be considered when it is practical to do so. Incorporating correlation analysis is technically and operationally challenging and potentially costly; but an analysis that does not consider interdependence provides less relevant information to users. When uncertainty is measured without proper correlation of interdependent inputs the degree of uncertainty may be overestimated.
- When measuring a portfolio of financial assets, interdependence and potential netting effects across products could be considered. However, such analysis should complement, rather than be a substitute for, a disaggregated asset by asset uncertainty measurement. The reason is that potential netting effects across assets are only relevant when a transaction of all the products of the portfolio takes place at the same time.

## Reporting Uncertainty

20 The Board has proposed in IVS 105 *Valuation Reporting*<sup>8</sup> the general principle that it is essential that the valuation report communicates the information necessary for proper understanding of the valuation. The proposed standard further provides that a valuation report shall not be ambiguous or misleading and shall provide the intended reader with a clear understanding of the valuation provided.

<sup>8</sup> Exposure Draft of New IVS issued June 2010, IVS 105.

- 21 The Board therefore considers that where uncertainty has a material effect on the valuation, it should be disclosed and explained. While a qualitative statement of any material uncertainty that has been identified should always be provided, the extent to which this can be supplemented by a quantitative assessment will depend upon the circumstances. Regard should be had to the principles discussed in paragraph 19.
- 22 Judgment on the materiality of uncertainty will depend upon the purpose and the context of the valuation. It should be considered by reference to the impact that the valuation of that asset has to the overall potential profits and losses in a portfolio or to the total assets or liabilities of the entity.
- 23 When providing a qualitative explanation of material uncertainty attention should be drawn to the cause of the uncertainty, any necessary assumptions that have been made in the valuation and, if practical and appropriate, how this is reflected in the reported valuation.
- 24 Where a quantitative measure of uncertainty is to be reported, the report should disclose the method used to estimate this, and the alternative assumptions made compared to the reported value.
- 25 It will also be recognised that a report that gave a false illusion of precision in the reporting of material uncertainty would also be contrary to the principle in IVS 105.

## IASB Proposals

- 26 The IASB exposure draft *Fair Value Measurement*<sup>9</sup> proposes that valuation measurements be classified according to whether the inputs used fall into one of three categories.
  - Level 1** inputs are “quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access on the measurement date”.
  - Level 2** inputs are “inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices)”.
  - Level 3** inputs are “inputs for the asset or liability that are not based on observable market data (unobservable inputs)”.
- 27 In December 2009, *IFRS 7 Financial Instruments: Disclosures* was issued which requires entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments to the entity’s financial position, and the nature and extent of risks arising from financial instruments to which the entity is exposed. It requires that for assets that are valued using Level 3, entities shall disclose the effect on value of a change to a reasonably possible alternative assumption. It further requires the disclosures to be presented in a tabular format unless another format is more appropriate.

<sup>9</sup> IASB ED/2009/5

- 28** More recently, the IASB has issued a further exposure draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*<sup>10</sup>, which is supplemental to the Fair Value Measurement exposure draft. This proposes that the current disclosure provisions in IFRS 7 for financial instruments in Level 3 be extended to fair value measurements for all other assets, unless these are specifically excluded by another standard. It also proposes a more specific requirement to provide a correlation analysis between different inputs.
- 29** The IASB's deliberations on this topic suggest that valuation uncertainty is only a material concern if "unobservable inputs" are used in the valuation. They also illustrate a preference for numeric illustrations of a range of possible outcomes. However, there is no explicit requirement for the nature or causes of uncertainty to be explained. The Board considers that the solutions identified by IASB do not provide an adequate framework for identifying where material uncertainty has affected the valuation process or its effective communication to those who may rely on that valuation.
- 30** The Board believes that it is inappropriate to assume that material uncertainty only affects assets valued in Level 3. Uncertainty can and does arise at all levels of the IASB's proposed valuation hierarchy. Although it is accepted that valuation uncertainty is normally negligible in Level 1 and will increase with the use of inputs in Levels 2 and 3, material uncertainty may still arise in Level 1 due to factors such as:
- the bid-offer spread.
  - unexpected changes in prices at the moment the transaction is executed due irregular behaviour of supply and demand.
  - the quality of the sources of market information used.
- 31** The Board also considers that using the proposed hierarchy as the primary means of identifying where material uncertainty is likely to arise fails to recognise that uncertainty in the valuation estimate can arise for reasons other than inconsistency or other difficulty with the inputs used. These reasons are addressed earlier in this discussion paper.
- 32** Finally, the Board considers that providing tabular and numeric illustrations of valuation uncertainty will rarely provide a user of a financial statement with useful information. There is significant potential for such disclosures to actually create or add to uncertainty in the mind of the user. The solutions identified by IASB seem to reflect a desire that valuations used in accounting be capable of strict numeric analysis and presentation. However, this approach fails to properly recognise that valuation requires the exercise of judgement and is not a purely numeric discipline. User confidence in valuations requires transparency in the entire process, and adequate explanation of all material factors that impact on the valuation, including any material uncertainty. This is more likely to be provided by a relevant commentary than a tabular presentation of alternative values.
- 33** A copy of the IVSC's response to the IASB's exposure draft<sup>11</sup> is annexed to this Discussion Paper.

<sup>10</sup> IASB ED/2010/7

<sup>11</sup> *ibid*

## Preliminary Conclusions

- 34** Uncertainty is inherent in any valuation because analysis of imperfect markets involves weighing the relevance of the available inputs to the required valuation objective. This often requires judgement.
- 35** Valuation users generally accept that valuations involve judgement. A third party's degree of confidence in the valuation will be dependent on knowing the identity and experience of the person making the judgement. Taking steps to maximise objectivity and minimise any tendency towards bias, for example by the use of valuers independent of the reporting entity or through rigorous internal control procedures is also vital if judgements are to be trusted. Disclosure of who undertook the valuation and of any control procedures in place to avoid bias or excessive subjectivity is more important in building users' confidence in valuations than any illustration of the effect of using different valuation assumptions.
- 36** Normal uncertainty, i.e. an observable variance in the prices for similar or identical assets on any given date is a feature of the particular market and therefore at least partially reflected in the pricing. When this uncertainty falls outside the normal parameters for the market and has had a material impact on the valuation process this becomes a matter that should be disclosed in the valuation report.
- 37** While a quantitative analysis and presentation may illustrate the effects of uncertainty, without a proper explanation it can actually be counterproductive. Consequently, adequate disclosure of material uncertainty should always include an explanation of the nature and cause of the uncertainty and its affect on the valuation process and valuation opinion regardless of whether a numeric analysis is provided or not.
- 38** That while for certain specific functions a quantitative calculation of uncertainty may be useful, (and some research may be appropriate to compare the advantages and disadvantages of methods that may be in use), such a process can only be useful in "scoring" uncertainty. It cannot eliminate it nor negate the price that would be paid between informed market participants on the valuation date.

## **IVSC Comments on IASB Exposure Draft 2010/7 Measurement uncertainty analysis disclosure for fair value measurements**

### **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.**

The answer to the first part of this question depends on exactly how the reader interprets the burden on the preparer, which is not clear from the draft. BC20 states that the Board has concluded that an entity should not be required to disclose quantitative information about the degree of correlation between unobservable inputs and that the Board's intended focus is on the effect on the valuation of a different combination of inputs. However, the use of the word "correlation analysis" both in the title of this exposure draft and in the proposed paragraph for inclusion suggest otherwise. The word "analysis" implies a full quantitative correlation analysis is required even if this is not disclosed. Illustrating the effect of alternative inputs that could reasonably have been used in the valuation is not a correlation analysis.

A further difficulty in interpreting the Board's intention is that considering the relationship between different inputs is inherent in any proper valuation process. So if a valuation has been prepared properly then the effect of the correlation between different inputs has already been considered and is reflected in the reported value. This again suggests that the Board intend some additional numeric analysis that supplements the normal valuation. If this is not the Board's intention, then we suggest that the term "correlation analysis" is being used inappropriately.

The view of IVSC is that although a full correlation analysis for every fair value reported would be both operationally challenging and expensive, the level of disclosure suggested by the Illustrative Example and the comment in BC20 would present a lesser burden. However, in answer to the second part of the question we consider that the disclosure described would rarely be appropriate. If introduced it would result in confusion and additional complexity to financial statements, which would not be advantageous to the majority of users.

Confusion would arise because illustrating how a value may have been higher or lower if different inputs had been used fundamentally undermines the concept of fair value as a price that would be agreed between market participants. The process of producing a market value requires the assessing of each input against the criteria that the majority of market buyers would adopt in formulating a bid. Not all buyers will adopt the same criteria and therefore are likely to reach different conclusions as the price they would be willing to pay. The role of the valuer is to identify the most likely outcome from the range of possible prices that would be bid. To then disclose the outlier bids that the valuer has rejected as being atypical of the market as a whole only serves to create uncertainty.

IVSC believes that valuation uncertainty only becomes a problem for users where the level of uncertainty increases to a level that is material. Materiality can be judged by reference to valuation tolerances that are regarded as normal for a particular asset type or market. Material uncertainty should be explicitly disclosed. Disclosure of the type envisaged by the exposure draft and contained in the illustrative example does not adequately convey the nature or extent of the uncertainty, whether this is at a level that is normal or abnormal for that market and that asset, or any justification for preferring the inputs that were actually used in the adopted fair value estimate. Identifying uncertainty without explaining it is of no help to users.

## 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?**

The question implies that an “uncertainty analysis” can be provided with or without the effect of “correlation between unobservable inputs” being disclosed. In the view of IVSC, simply making a reference to the fact that correlation between different unobservable inputs has been taken into account does not make the disclosure any more or less meaningful. It is as useful as saying a weather forecast has taken into account the possibility of sunshine or rain. As already explained, where there are different inputs used in the valuation process any correlation between them is considered as part of that process, although a detailed statistical analysis of that correlation is infrequently deemed necessary.

Uncertainty over specific inputs is only one of a number of potential sources of uncertainty. We reiterate our view that the proposed disclosures are inappropriate. They manage to combine a one dimensional and simplistic approach to the question of valuation uncertainty with an unhelpful complication in the presentation of valuation 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 measurement categorised in 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.**

The question, and indeed the proposal, reveals a belief that valuation uncertainty is only an issue in the case of assets valued using Level 3 inputs. This is also an over simplification. Valuation uncertainty is not solely dependent on the inputs used, and can also arise in assets customarily valued in Levels 1 and 2. While it is accepted that material uncertainty is more prevalent in Level 3, it is not exclusive to this category.

The IASB's stated purpose of fair value measurement is to give the best estimate of the price that would be received to sell an asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date. It is therefore unhelpful to users to be given alternative estimates, without a clear explanation of why one is preferred to the others.

The IVSC recognises that uncertainty is inherent in all valuations. It can also have different causes, ranging from external economic or political events to internal features of the asset being valued. A fundamental principle of the International Valuation Standards is that valuation reports should not be ambiguous or misleading and should provide the intended reader with a clear understanding of the valuation provided. To fail to communicate any material uncertainty that is present on the valuation date to a user of the valuation would be contrary to this principle.

Although a quantitative measure of valuation uncertainty for certain types of financial asset may be of some benefit to users of financial statements, this data should only be considered in the context of a suitable explanatory statement that identifies the source or sources of uncertainty and impact they have had on the valuation process. For most other types of asset such an explanatory statement is more relevant than any attempt at a numeric expression of material uncertainty. Accordingly, where material valuation uncertainty exists we recommend that this should be disclosed in financial statements by way of a suitable qualitative statement in all cases; a quantitative statement can be an additional option in cases where it assists in illustrating the qualitative statement.

The level of certainty or uncertainty in a valuation is also directly related to the confidence that a user has in it. Most sophisticated users of valuations understand that they are opinions or estimates and that to a greater or lesser degree involve judgements. Knowledge that judgement has been exercised as objectively as possible is a vital component in building user confidence.

IVSC notes that in IAS 16 para 77 there are requirements to disclose who prepared the valuations, the methods and significant assumptions used and the key inputs used. Para 75 of IAS 40 contains similar provisions. Although IAS 39 and IFRS 7 have no equivalent requirement, it is noted that in the report of the IASB Expert Advisory Panel<sup>1</sup> considerable emphasis was placed on the desirability of disclosing the "control environment", as a means of maximising the objectivity of fair value measurements.

We therefore find it strange that the Fair Value Measurement draft apparently fails to recognise that wherever measurement involves judgement, confidence and credibility in a valuation opinion depends at least as much on the status and freedom from bias of the person or body issuing that opinion as it does from the mechanics of the process they have used.

<sup>1</sup> Measuring and disclosing the fair value of financial instruments in markets that are no longer active – IASB October 2008



In conclusion, the proposed disclosure shares the same fundamental flaw as other proposals in the 2009 Fair Value Measurement Exposure Draft in that by referring to the correlation between inputs it is focussing on a single element of the valuation process and not the information that users of financial statements need to know. For accounting literature to emphasise selective elements of the normal valuation process or highlight valuation concepts out of context is not helpful to users and is positively unhelpful to promulgating good valuation practice globally, a point that applies with equal force to the redundant discussion on highest and best use in ED/2009/5.

If the goal is to improve investor confidence in valuation, we believe that IFRS should require disclosures similar to those currently appearing in IAS 16 and 40 generally. An explanation of any material uncertainty existing at the valuation date can then be added to the list of matters to be disclosed.

*September 2010*