

1710-100 Comment Letter No. 72 233 N. Michigan Ave., Suite 2500 Chicago, Illinois 60601

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Mr. Russell Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

File Reference No. 1710-100—Exposure Draft, *Improving Disclosures about Fair Value Measurements* 

Dear Mr. Golden:

BDO Seidman is pleased to offer comments on the Exposure Draft of the Proposed Accounting Standards Update, *Improving Disclosures about Fair Value Measurements*. We share the view of a number of constituents that disclosures about fair value measurements should be enhanced. We agree most of the Board's proposals in the ED represent improvements, but believe the method of disclosing sensitivities for Level 3 fair value estimates will not be cost-beneficial. In lieu of disclosing what could be a very large number of alternative point estimates and related narrative, we believe the Board should require disclosing the range of reasonably possible alternatives on a qualitative basis. This should still help users better understand the degree of uncertainty in Level 3 estimates without imposing excessive preparation and audit costs.

We discuss this point in greater detail below, and have also included our responses to the other questions posed in the ED.

## Responses to Questions

Issue 1: With respect to the disclosure of the effect of changes in reasonably possible, significant, alternative inputs for Level 3 fair value measurements for each class of assets and liabilities (sometimes also referred to as sensitivity disclosures), the Board is seeking input from:

- 1. Financial statement preparers about their operationality and costs
- 2. IFRS financial statement preparers about the approach they plan to use to comply with a similar disclosure requirement in IFRS 7
- 3. Financial statements users about their usefulness—more specifically, a discussion of how they would benefit from, and use, such disclosures.

We believe the preparation and audit costs of the proposed Level 3 sensitivity disclosures will likely exceed their benefits, and note this is consistent with the views of certain Board members who dissented to including this requirement in the ED. However, user input will be important as the Board redeliberates comments received on the ED and finalizes its cost/benefit assessment.

As indicated in the proposed amendments to paragraph 820-10-50-2(f), a preparer must first determine whether a change to a significant unobservable input is "reasonably possible," as defined in the Master Glossary to the Codification. Practitioners may attach slightly different quantitative thresholds to the terms "remote" and "less than likely," but this is an admittedly



broad range. Next, preparers must narrow the range of reasonably possible changes to those that "significantly" increase or decrease the fair value estimate. This two-step screening process has the potential to result in numerous permutations of the original fair value measurement. For instance, if an alternative is reasonably possible at the 20% level of probability and it represents a significant increase or decrease to the fair value estimate, it seems quite likely alternatives that are 19% and 21% probable would also be significant. If reasonably possible is interpreted to mean a range of probabilities from 5% to 49%, it implies a very large number of alternative point estimates. Further, proposed "Case D: Disclosure—Effect of Reasonably Possible Alternative Inputs on Fair Value Measurements Using Significant Unobservable Inputs (Level 3)" indicates one and a half pages of single-spaced narrative may be necessary to describe the impact of *only two* reasonably possible alternatives. When extrapolated across multiple inputs for scores of Level 3 estimates, we question whether the volume of resulting alternatives would be useful to a reader of financial statements or practical to disclose.

We also note *Improving Disclosures about Financial Instruments* (amendments to IFRS 7) did not provide an example of how sensitivity disclosures should be presented, even though its requirement in paragraph 27B(e) for such disclosure used substantially the same language as what is proposed in paragraph 820-10-50-2(f) of the ED. As a result, it appears the example contained in "Case D" may lead to diversity in practice between US GAAP and IFRS as it relates to the level of detail at which reasonably possible alternatives are disclosed. The input solicited by the Board from IFRS preparers should be helpful in this regard.

However, our concerns extend beyond the potential length of sensitivity disclosures. In our 2004 comment letter on the Exposure Draft, *Fair Value Measurements*, we stated "Fair value measurements raise significant auditing issues in addition to significant accounting issues. We hope that the FASB will coordinate any expansion of fair value measurements with the PCAOB and the AICPA, so that improved auditing standards can become effective at the same time as expanded fair value measurements." A continuing audit challenge relates to how an auditor provides assurance for managerial estimates and expectations that are inherently uncertain. In that regard, Case D's language about management's beliefs is a good example:

- The reporting entity concludes that the probability of default and loss severity were the most sensitive inputs....
- The reporting entity believes that a range of XX basis points greater than and XX basis points less than the weighted-average constant default rate...represent the reasonably possible alternative inputs....
- These inputs consider the higher risk profile of Alt-A over prime securities, as well as the declining economic
  conditions that may lead to an increased likelihood of default and loss severity at year-end.

Determining and applying the audit procedures that are necessary to test these assertions can be quite costly. In addition, the Federal Advisory Committee on Improvements to Financial Reporting ("CIFiR") struck a similar theme in its recommendation of a Disclosure Framework, which included the notion of using sensitivity disclosures to provide additional insight for users into fair value estimates. CIFiR stated:

We recognize our disclosure recommendation incorporates factual information that, historically, is presented in audited footnotes, as well as analytical and forward-looking discussions that are typically part of MD&A narratives in SEC filings. We are also aware there are important considerations regarding audit assurance, legal safe harbors, and other liability issues when determining the placement of disclosures in an SEC filing (e.g., footnotes or MD&A). Therefore, an optimally-designed disclosure framework should be developed by the FASB under close coordination with the SEC so that these factors are considered, and so that the Commission amends its guidance where appropriate. <sup>1</sup>

<sup>1</sup> Final Report of the Advisory Committee on Improvements to Financial Reporting, August 1, 2008, pg. 37.

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We believe a significant expansion of sensitivity disclosures as proposed by the ED will compound the practical challenges that already exist in this uncertain area of financial reporting. Specifically, preparers and auditors will both incur additional costs to complete their tasks, which are ultimately borne by shareholders.

In our view, the degree of uncertainty associated with Level 3 fair value estimates may be more efficiently signaled to users by requiring sensitivity disclosures to be a qualitative description of those that are the most and least likely to occur within the range of reasonably possible alternatives for each class of assets and liabilities. In this context, we note users should already be aware that Level 3 estimates are the least reliable amounts in the fair value hierarchy, by definition.

At this point, it is unclear what level of effort would be required of preparers to describe the range of reasonably possible alternatives on a qualitative basis. The Board may wish to explore this idea further in its redeliberations. It also could consider a requirement to disclose this information on a supplemental pro forma basis to mitigate audit costs, similar to the disclosures in Topic 805-10-50-2(h) depicting the combined results of operations of an acquirer and target company. However, we do not perceive a lessening of the concerns around "legal safe harbors, and other liability issues..." that CIFiR articulated. Consequently, we expect practice to continue to vary with respect to the level of detail disclosed about managerial expectations and uncertainties, irrespective of the final disclosure requirements.

Further, we observe that the FASB's new Disclosure Framework project is intended, in part, to "seek ways to better integrate information provided in financial statements, MD&A, and other parts of a company's public reporting package." If that project addresses the considerations noted above, it may mitigate the incremental costs that we believe will result from the proposed ED. But currently, from a cost/benefit perspective, it does not appear a large volume of sensitivities will result in a higher net benefit to the majority of users compared to our possible recommendation of a qualitative disclosure on a supplemental pro forma basis.

Issue 2: With respect to the reconciliation (sometimes referred to as a roll forward) of fair values using significant unobservable inputs (Level 3), the amendments in this proposed Update would require separate disclosure of purchases, sales, issuances, and settlements during the reporting period. Is this proposed requirement operational? If not, why?

We do not believe there are any significant audit impediments to the proposed reconciliation requirement, as amended. Therefore, we believe the incremental benefits it will provide for users will come with a relatively low marginal cost.

## Issue 3: Is the proposed effective date operational? In particular:

- 1. Will entities be able to provide information about the effect of reasonably possible alternative inputs for level 3 fair value measurements for interim reporting periods ending after March 15, 2010?
- 2. Are there any reasons why the Board should provide a different effective date for nonpublic companies?

With the exception of the sensitivity disclosures, we believe the proposed effective date is operational for all companies.



For public and private companies with more than a few Level 3 fair value estimates, we do not believe the sensitivity disclosures – as proposed – will be cost-beneficial in any period, and therefore do not believe the March 15, 2010 effective date is operational. Specifically, changes in a company's investment portfolio and the valuation models used to measure the investments would create an endless stream of work under the ED.

However, if the Board ultimately retains the sensitivity disclosure requirement in the final ASU, we believe it is even less cost-beneficial on a quarterly basis compared to annual periods due to the shorter filing deadlines that apply to SEC registrants. For that reason, if the ED is adopted, we believe it should only apply to annual periods, as guidance already exists that would require disclosure of significant changes that have occurred during an interim period since the last annual reporting date.

## Other Comments

- We agree judgment will be required to determine the appropriate classes of assets and liabilities that should be disclosed. We suggest clarifying in the final ASU how the guidance for identifying a class in paragraph 820-10-50-2A interacts with the definition of "class" in the Board's recently Proposed Statement, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. In our comment letter on that project, we recommended the Board clarify that receivables carried at fair value should be excluded from its scope. However, if the Board decides receivables carried at fair value should be included in the scope of the credit quality ED, the overlapping terminology in both EDs will likely cause confusion, which could be avoided by more clearly defining the term "class" in this ED.
- It would be helpful to define the term "significantly" as it is used in paragraph 820-10-50-2(f), or at least to indicate whether it is intended to exceed amounts that are "material," as that term is defined in Statement of Financial Accounting Concepts No. 2.<sup>2</sup> In the basis for conclusions to Statement 167,<sup>3</sup> the Board agreed with certain users who "expressed concern that practitioners may apply significance at a level in excess of material and, thus, would avoid determining whether the entity in which they have an interest is a variable interest entity."

We can envision similar concerns about the interrelationship of "significance" and "materiality" for purposes of determining whether Level 3 sensitivity disclosures are required, which could be avoided with additional clarification in the final ASU.

• Proposed "Case D" contains language stating "The reporting entity concludes that the probability of default and loss severity were the most sensitive inputs into Alt-A and prime residential-mortgage-backed securities fair value measurements throughout 20XX." Read in isolation, this language seems to imply there may have been other reasonably possible and significant alternative inputs that were not disclosed because they were not considered the most sensitive, which would be inconsistent with paragraph 820-10-50-2(f).

<sup>&</sup>lt;sup>2</sup> "The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."

<sup>&</sup>lt;sup>3</sup> FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R). See paragraph A8.



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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Lee Graul, National Director of Accounting, at (312) 616-4667 or Adam Brown, Partner in the National Accounting Department, at (214) 665-0673.

Very truly yours, /s/ BDO Seidman, LLP