MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Kapko (ext. 317)
Subject:	Minutes of the December 15, 2004 FVM Board Meeting
Date:	December 21, 2004
cc:	Bielstein, L. Smith, Petrone, Fair Value Team, Revenue Recognition Team, Business Combinations Team, Swift, Polley, Gabriele, Getz, Thompson, Mahoney, Leisenring (IASB), J. Paul (IASB), G. Ryltsova (IASB), P. Martin (CICA), FASB Intranet

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic:	Significant issues raised by respondents to the proposed FASB Statement, *Fair Value Measurements*, relating to the fair value hierarchy, reference markets, and credit standing in liability measurements.
Basis for Discussion:	Memorandum 1 dated November 24, 2004 and Memorandums 2 and 3 dated December 6, 2004, and audience handout (attached)
Length of Discussion:	8:30 a.m. to 10:30 a.m.

Attendance:

Board members present:	Batavick, Crooch, Herz, Schieneman, Schipper, Seidman, and Trott
Board members absent:	None
Staff in charge of topic:	MacDonald
Other staff at Board table:	Munro, Kapko, Pinson, and E.Smith
Outside participants:	None

Summary of Decisions Reached

The Board discussed significant issues raised by respondents to the proposed FASB Statement, *Fair Value Measurements* (FVM), relating to the fair value hierarchy, reference markets within the hierarchy, and credit standing in liability measurements.

The Board clarified that the objective of the fair value hierarchy is to prioritize the inputs to valuation techniques used to estimate fair value to provide a framework for assessing the relative reliability of the estimates, giving the highest priority to quoted prices in active markets and the lowest priority to an entity's own estimates and assumptions. To more clearly convey a continuum of inputs, the Board decided to adopt a four-level hierarchy and revise certain aspects of the guidance contained within the hierarchy. Specifically:

1. The Board revised the guidance within Level 1 to refer to the use of quoted prices in active markets for identical assets or liabilities, except in limited situations in which those prices might need to be adjusted within a lower level of the hierarchy because those prices are not readily available or representative of fair value (that is, marketplace participants would not currently transact at those prices). The Board agreed that in limited situations in which individual price quotes are readily available and representative of fair value but are not readily obtainable for all of the assets and liabilities to be measured, a pricing method commonly used in the market may be used within Level 1 as a practical expedient.

2. The Board revised the guidance within Level 2 to eliminate the objectively determinable criterion, thereby referring to the use of quoted prices in active markets for similar assets or liabilities, adjusted as appropriate for differences.

3. The Board revised the guidance within Level 3 to eliminate the undue cost and effort criterion, thereby referring to the use of other available market inputs.

4. The Board added a new Level 4 to refer to the use of entity inputs in the absence of available market inputs, affirming that within Level 4, the measurement objective is fair value.

The Board clarified the application of the reference market principle within the fair value hierarchy, as revised. Specifically:

1. For Level 1 estimates, the Board clarified that the appropriate reference market is the market for the asset or liability the entity has the ability to currently access—the principal market (as determined under ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies*, or otherwise, based on volume data) or, in the absence of a principal market, the most advantageous market.

2. For other estimates, the Board clarified that the appropriate reference market is the market within which inputs relevant to the asset or liability being measured can be observed even if the entity does not have the ability to currently access that market (for example, a restricted security).

The Board clarified that in situations in which the location of the asset or liability being measured is a characteristic of that asset or liability (for example, a physical commodity) the related transportation costs (the costs to access the appropriate reference market) should be considered in the estimate of fair value. Those costs are different from transaction costs (the incremental direct costs to transact in the appropriate reference market), which should not be considered in the estimate of fair value.

The Board affirmed its decision to include within the definition of fair value the credit standing concept in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. At a future meeting, the Board plans to discuss whether and, if so, how to amend existing pronouncements that require liability measurements at fair value but do not require that an entity consider the effect of its credit standing in those measurements.

<u>Objective of Meeting:</u>

The objectives of the meeting were to discuss issues raised by respondents to the proposed FVM Statement related to the fair value hierarchy, reference markets, and credit standing in liability measurements.

<u>Matters Discussed and Decisions Reached:</u>

Fair Value Hierarchy

1. Ms. MacDonald explained that many respondents viewed the proposed hierarchy as overly rigid and not conveying, as well as it otherwise could, a

continuum of inputs, with market inputs ranked as the most reliable and entity inputs ranked as the least reliable. She said that as a basis for considering revisions to the hierarchy, the staff recommends that the Board clarify the hierarchy objective indicated in the proposed FVM Statement, specifically, as providing a framework for assessing the relative reliability of the estimates, whether used for measurement or disclosure purposes.

2. All Board members agreed with the staff recommendation. Mr. Trott emphasized that the ranking of the inputs is important. Ms. Seidman agreed, stating that it would enhance the Statement to explicitly state the objective, emphasizing the continuum of inputs within the hierarchy and the ranking of those inputs relative to reliability, rather than a prescription of how to do the estimate.

Level 1—Readily Available and Representative of Fair Value

3. Ms. MacDonald explained that some respondents narrowly interpreted the Level 1 guidance as precluding adjustments to quoted prices. In that regard, respondents referred to possible conflicts with ASR 118, which requires adjustments to quoted prices in certain specified situations.

4. Ms. MacDonald said that was not the Board's intent, as indicated by the guidance contained elsewhere within the proposed FVM Statement (for example, in the context of active markets and significant subsequent events). She said that to more clearly convey its intent in that regard, the staff recommends that the Board revise the related guidance to refer to the use of quoted prices in active markets for identical assets or liabilities that are readily available and representative of fair value, and include within Appendix B examples of the limited situations in which that might not be the case.

5. All Board members agreed with that staff recommendation, subject to clarification.

6. Ms. Seidman agreed that a quoted price should be representative of fair value. However, because the Board has not considered all possible situations in which that might not be the case, she suggested that the Statement convey that

the underlying rationale for any resulting adjustment should be that a marketplace participant would not currently transact at that price.

Level 1—Readily Obtainable

7. Ms. MacDonald explained that a few respondents referred to situations in which quoted prices are readily available and representative of fair value, but not readily obtainable (where the number of items to be measured at fair value is such that it is impracticable to obtain price quotes for each individual item). Although the proposed FVM Statement does not address those issues, the staff does not believe that the Statement should preclude practicability considerations in those limited situations. She said that in response, the staff recommends that the Board clarify that in those limited situations, a pricing method generally accepted in the market may be used as a practical expedient within Level 1 to estimate fair value.

8. All Board members agreed with that staff recommendation, subject to clarification to clearly communicate the practical expedient and its limited application within Level 1.

9. In that regard, Mr. Herz clarified that within Level 1, the use of such valuation techniques (matrix pricing) is a pure practical expedient, where individual price quotes in active markets could be obtained for all of the assets or liabilities to be measured but, for practical reasons, are not.

10. Ms. Schipper agreed. She emphasized that within Level 1, the use of such valuation techniques (data aggregation techniques) should result in a price estimate that would approximate the estimate that would have resulted had individual price quotes in active markets been used; in other words, such techniques should replicate the quoted price. She said that there must be an evidentiary basis for concluding that the data aggregation technique used will provide a reliable price, stating, however, that the burden of proof is on the measurer. If that burden of proof is met, the estimate is a Level 1 estimate. Otherwise, it is a lower level estimate.

11. Ms. Seidman further clarified that where individual price quotes in active markets could be obtained for some but not all of the assets and liabilities to be measured, the requisite adjustments render the estimate a lower level estimate.

Level 2

12. Ms. MacDonald explained that nearly all respondents expressed concerns about the objectively determinable criterion for adjustments within Level 2. In particular, they indicated that because all adjustments require some degree of subjectivity, Level 2 would be too narrow. She said that in response, the staff recommends that the Board revise the related guidance to refer to the use of quoted prices in active markets for similar assets or liabilities, adjusted as appropriate for differences (between the asset or liability being measured and other similar assets or liabilities), without the "objectively determinable" criterion. She said that the staff believes that doing so would better achieve the hierarchy objective.

13. All Board members agreed with that staff recommendation, subject to clarification.

14. Ms. Schipper clarified that the Level 2 adjustments should be determined based on market inputs so that they reflect the adjustments that marketplace participants would make. She also said that the reason for the revision, to broaden the use of Level 2 beyond what commentators had in mind, should be clear in the Statement.

Level 3

15. Ms. MacDonald said that Level 3 refers to the use of market inputs (including prices in less active markets) that are available "without undue cost and effort." She said that some respondents indicated that undue cost and effort is inappropriate as a basis for excluding from estimates of fair value market inputs that are otherwise available. She said that in response, the staff recommends that the Board revise the related guidance to refer to the use of available market inputs without the undue cost and effort criterion.

16. All Board members agreed with that staff recommendation, subject to clarifications to distinguish the practical expedient within Level 1 (for readily obtainable price quotes) and removal of the undue cost and effort criterion within Level 3 (to emphasize the use of all available market inputs).

Level 4

17. Ms. MacDonald explained that Level 3 also refers to the use of entity inputs if market inputs are not available (without undue cost and effort). Many respondents said that Level 3 would be overly broad. In particular, they expressed concerns about combining estimates that rely on both market and entity inputs and, thus, are not of equal reliability, within one level (especially for disclosure purposes). Ms. MacDonald said that in response, the staff recommends that the Board split Level 3 and add a new Level 4 to separately refer to the use of entity inputs, emphasizing within the new Level 4 that the measurement objective remains the same—fair value. Accordingly, the entity inputs used to estimate fair value (within Level 4) should be considered within market parameters. The staff believes that segregating market inputs from entity inputs would better achieve the hierarchy objective.

18. All Board members agreed with that staff recommendation, but to varying degrees.

19. In particular, Mr. Herz said that he has reservations about requiring fair value measurements using entity specific inputs to, in effect, construct hypothetical "markets." He said that *market-based* is a powerful term and he is concerned that it might loose value if it is tainted by including values based solely on entity inputs. He said that to him, this is a communication problem, in particular with respect to the notion that a market-based measurement can result from the use of entity inputs. Mr. Herz said that he does not think that hypothetical markets can produce values that are representationally faithful, especially for liabilities because, in contrast to assets, liabilities are not generally bought and sold in multiple markets. He said that he would prefer to "cut off" fair value at the new proposed Level 3 and relabel the new Level 4 something other than fair value.

20. Mr. Trott said that relabeling Level 4, in effect, specifying a new (default) measurement to a fair value measurement would be confusing, and present even more of a communication problem.

21. Ms. Schipper agreed. She said that she considered the concerns expressed by Mr. Herz. In that regard, she pointed out that entity inputs can be highly verifiable; they arise in a transaction where there is not an external counterparty and are used as a basis for replicating a transaction in which there is an external counter party. She said that while such a transaction would require a “hypothetical construct” (market) from the perspective of a marketplace participant, she believes that the resulting estimate is both verifiable and representationally faithful, which are the essential elements of reliability. Accordingly, a Level 4 estimate is a representationally faithful estimate of fair value.

22. Ms. Seidman said that while she agrees with the staff recommendation, she shares some of Mr. Herz’s concerns. However, at this time (in this project), the Board should not change existing U.S. generally accepted accounting principles (GAAP) with respect to whether and when fair value is the measurement attribute that should be applied. In these existing pronouncements the Board has previously concluded that fair value is the relevant measurement attribute. She also said that the Board will explicitly consider relevance and reliability in the selection of measurement attributes in the conceptual framework project and will have a chance then to consider what the relevant measurement attributes should be.

Level 1 Reference Markets

23. Ms. MacDonald said that as a follow-up to the November 10, 2004 meeting, the staff considered the application of the reference market principle within the fair value hierarchy, as revised.

24. Ms. MacDonald pointed out that within the proposed FVM Statement, the reference market principle is explicit only with respect to Level 1. In that regard, the related guidance specifies that in situations in which an entity has the ability

to currently access multiple (active) markets, the appropriate reference market is the most advantageous market. In comments, respondents said that for varying reasons, the appropriate reference market should be the principal market, consistent with the guidance in ASR 118.

25. Ms. MacDonald said that in response, the staff recommends that the Board revise the related guidance to clarify that the appropriate reference market for Level 1 is the market for the asset or liability the entity has the ability to currently access—the principal market (as determined under ASR 118 or otherwise, based on volume data) or, in the absence of a principal market, the most advantageous market. She added that as a practical matter, the staff believes that for the asset or liability being measured, it would be reasonable to presume that the principal market would represent the most advantageous market and, thus, the market within which the entity would transact.

26. All Board members agreed with that staff recommendation.

Other Reference Markets

27. Ms. MacDonald said that for estimates outside of Level 1, the emphasis should be on the use of observable inputs relevant to the asset or liability being measured that result in the best estimate of fair value in the circumstances, not the ability of the entity to currently access the markets within which inputs are measured. She said that for those estimates, the staff recommends that the Board revise the reference market principle accordingly.

28. All Board members agreed with the staff recommendation. However, Mr. Herz reiterated his concerns about fair value measurements in situations in which reference markets are "hypothetical" and entity inputs are used within Level 4 to, in effect, "construct" those markets.

Transaction versus Transportation Costs

29. Ms. MacDonald said that in applying a most advantageous market approach, the proposed FVM Statement specifies that transaction costs should be considered in determining most advantageous markets but not in estimates of fair value using prices in those markets. She said that some respondents

pointed out that items, such as physical commodities, often have different prices in different locations largely due to transportation costs. The respondents said that the related guidance could be interpreted as including those transportation costs within the transaction costs that would not be considered in the estimates of fair value, which would produce anomalous results.

30. Ms. MacDonald said that the staff does not believe that it was the Board's intent to broadly define transaction costs to include those transportation costs. To more clearly convey its intent in that regard, the staff recommends that the Board clarify that in situations in which the location of the asset or liability being measured is a characteristic of that asset or liability (for example, a physical commodity) the related transportation costs (the costs to access the appropriate reference market) should be considered in the estimate of fair value. Those costs are different from transaction costs (the incremental direct costs to transact in the appropriate reference market), which should not be considered in the estimate of fair value.

31. All Board members agreed with that staff recommendation, subject to clarification.

32. Ms. Schipper clarified that there should be a distinction between items for which location is a characteristic and items for which location is not a characteristic, where the former (but not the latter) could be subject to both transportation costs and transaction costs. She agreed that the Board should clarify the related guidance accordingly.

33. Ms. Seidman clarified that the related guidance would apply for all estimates of fair value (not just those within Level 1) and suggested that the guidance emphasize that location should be a "current" (as-is) characteristic of the asset or liability and, further, distinguish such costs from other costs, for example, the cost of doing a securitization (which should not be considered a market "access" cost).

Credit Standing and Liability Remeasurements

34. Ms. MacDonald said that as a follow-up to its November 10, 2004 meeting, the staff considered the effect on existing pronouncements of including the credit standing concept in Concepts Statement 7 in the definition of fair value in the proposed FVM Statement (thereby elevating that concept to Level A GAAP). She said that the most significant effect would be on the liability remeasurements under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (derivative payables).

35. Ms. MacDonald said that at this time, the threshold question is whether to apply the credit standing concept to all liability measurements. In that regard, the staff recommends that the Board affirm its decision to include the credit standing concept in the definition of fair value. Ms. MacDonald said that it is a tough issue, especially considering respondents' concerns in that regard. However, the staff believes that the proposed FVM Statement, which seeks to clarify the fair value measurement concept within Level A GAAP, should clearly set out the fair value measurement concept within Level A GAAP. Possible deviations from that fair value measurement concept (decisions on whether to apply that measurement concept in full or in part, without a credit standing component) should be separately considered, on a project-by-project basis.

36. Four Board members [Mr. Crooch, Mr. Herz, Ms. Schipper, and Mr. Trott] agreed with that staff recommendation to include the credit standing concept in the definition of fair value. Mr. Batavick and Ms. Seidman agreed with that staff recommendation, subject to further consideration of whether and, if so, how to amend those existing pronouncements that currently require liability remeasurements at fair value. Mr. Scheineman abstained.

37. Ms. Schipper said that she would object to a fair value definition that does not include credit standing. Ms. Seidman said that conceptually, the fair value definition should include credit standing. However, Ms. Seidman shares the concerns of the respondents about the relevance of the resulting measurement. She said that she is not convinced that it accurately reflects the underlying economics and is particularly concerned about the effect of including that

concept in the definition of fair value for future liabilities that may be measured at fair value.

Follow-up Items:

38. The Board asked the staff to address whether and, if so, how to amend existing pronouncements that require remeasurements of liabilities at fair value together with other related amendments.

General Announcements:

39. None.

Financial Accounting Standards Board

Board Meeting Handout

ATTACHMENT

FAIR VALUE MEASUREMENT PROJECT
December 15, 2004

At the December 15, 2004 meeting, the Board will continue redeliberations of the proposed FASB Statement, *Fair Value Measurements* (FVM), considering issues raised by respondents in comment letters and at the September 21, 2004, public roundtable discussion. The issues to be discussed relate to (1) the fair value hierarchy, (2) reference markets, and (3) credit standing and liability remeasurements.

1. Fair Value Hierarchy

The proposed FVM Statement establishes a fair value hierarchy, which ranks the inputs used in valuation techniques to estimate fair value. In general, many respondents indicated that the hierarchy is too rigid (rules-based) and does not necessarily convey a continuum of inputs, with market inputs rated as the most reliable and entity inputs rated as the least reliable. In response to those and other related comments, the Board will discuss the need to clarify or revise aspects of the hierarchy, focusing on the following:

a. *The hierarchy objective*. The Board will clarify the hierarchy objective as ranking the inputs used in valuation techniques to estimate fair value to provide a framework for assessing the relative reliability of the estimates, whether used for purposes of measurement, disclosure, or both.

b. *Level 1*. The Level 1 guidance refers to the use of quoted prices in active markets for identical assets or liabilities, unadjusted. Some respondents referred to possible conflicts with ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies*, which requires adjustments to quoted prices in certain specified circumstances. In response, the Board will clarify whether and, if so, when quoted prices should be adjusted (within a lower level of the hierarchy), considering situations in which those prices are not (1) readily available (if the market for a particular asset or liability is "thin"), (2) representative of fair value (if an event occurs after the close of a market but before the end of the reporting period that causes a price to become "stale"), and (3) readily obtainable (if the number of items to be measured makes it impracticable to obtain price quotes for each individual item).

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c. *Level 2*. The Level 2 guidance refers to the use of quoted prices in active markets for similar assets or liabilities, adjusted for differences that are "objectively determinable." Many respondents indicated that because all adjustments require some degree of subjectivity, Level 2 would be too narrow (rarely used). In response, the Board will discuss whether to eliminate the objectively determinable criterion, thereby broadening Level 2.

d. *Level 3 market inputs*. The Level 3 guidance refers to the use of other market inputs that are available without "undue cost and effort." Some respondents indicated that undue cost and effort is inappropriate as a basis for excluding from estimates of fair value market inputs that are otherwise available. In response, the Board will discuss whether to eliminate the undue cost and effort criterion.

e. *Level 3 entity inputs*. The Level 3 guidance refers to the use of entity inputs as a practical expedient in situations in which market inputs are not available (without undue cost and effort). Many respondents expressed concerns about combining estimates that rely on other market inputs (upper Level 3) with estimates that rely on entity inputs (lower Level 3), especially for purposes of disclosure. In response, the Board will discuss whether and, if so, how to separately refer to those entity inputs within the fair value hierarchy, considering the measurement objective (fair value).

2. Reference Markets

As a follow-up to its November 10, 2004 meeting, the Board will consider the application of the general reference market principle in the context of the fair value hierarchy, as revised. The reference market refers to the market for the asset or liability being measured that the entity looks to as a basis for selecting the inputs used to estimate fair value.

a. *Level 1 estimates (PxQ)*. Within the context of Level 1, that is, when using quoted prices in active markets (unadjusted) to estimate fair value, the reference market is the market for the asset or liability the entity has the ability to immediately (currently) access. The proposed FVM Statement notes that in many cases, that market will be the market in which the preponderance of transactions for an asset or liability occur, that is, the principal market. However, it specifies that if an entity has the ability to currently access more than one market, that market is the market with the price that maximizes (minimizes) the net amount that would be received (incurred) in a current transaction for the asset (liability), that is, the most advantageous market. Many respondents said that the reference market should be the principal market, even if an entity has the ability to currently access other potentially more advantageous markets.

In response, the Board will discuss the following:

(1) Whether the Level 1 reference market should be the principal market, even if the entity has access to other potentially more advantageous markets and, if so, whether the Level 1 reference market should be the most advantageous market in the absence of a principal market.

(2) If applicable, the costs that should be considered when using prices in most advantageous markets to estimate fair value, distinguishing between costs to transact in most advantageous markets (transaction costs) and costs to access those markets attributable to location differences (transportation costs).

b. *Other estimates*. For other estimates, the Board will consider whether reference market principle should emphasize the use of observable inputs relevant to the asset or liability being measured that result in the best estimate of fair value in the circumstances, rather than the ability of the entity to currently access the reference market (and the inputs observed within that market).

3. Credit Standing and Liability Remeasurements

As a follow-up to its November 10, 2004 meeting, the Board will discuss whether to include the credit standing concept in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, considering the implications on existing pronouncements that require liability remeasurements at fair value and respondents' comments in that regard.