Financial Accounting Standards Board

**MINUTES**

Financial Accounting Standards Board

**To:** Board Members

**From:** FVM/FSP Team (Arveseth, ext. 384)

**Subject:** FVM External Reviewer Comments **Date:** July 14, 2006

**cc:** Bielstein, L. Smith, Fair Value Team, Business Combinations Team, Derivatives Disclosures Team, McBeth, Polley, Gabriele, Carney, Allen, Sutay, Leisenring (IASB), Nelson (IASB), 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.*

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| Topic: | Issues raised by external reviewers to the FVM draft |
| Basis for Discussion: | Memorandum dated June 16, 2006 |
| Length of Discussion: | 9:30 a.m. to 10:30 a.m. |
| Attendance: | |
| Board members present: | FASB: Batavick, Crooch, Herz, Schipper, Seidman, Trott, and Young (Linsmeier observed the meeting)<br>IASB: Leisenring |
| Board members absent: | None |
| Staff in charge of topic: | MacDonald |
| Other staff at Board table: | Thuener, Todorova Stevens, Arveseth, Lott, Bielstein, and Smith |
| Outside participants: | None |

## Summary of Decisions Reached

The Board discussed comments received from certain external reviewers of a draft of the final FASB Statement on fair value measurements. In response, the Board:

1. Affirmed but clarified the current definition of fair value to refer to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
2. Clarified that inputs to valuation techniques should reflect the assumptions that market participants would use in pricing an asset or liability, including assumptions about risk. In the absence of observable inputs, a fair value measurement should be determined using unobservable inputs reflecting the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability developed based on the best information available in the circumstances, including the reporting entity's own data provided that no contrary data indicate that market participants would use different assumptions.
3. Removed the guidance from the draft Statement for offsetting long and short positions in the same instrument.
4. Decided to require qualitative disclosures about unobservable inputs used for nonrecurring fair value measurements within Level 3 (including a description of the inputs and the information used to develop the inputs).
5. Decided to allow derivative assets and liabilities measured within Level 3 to be presented net for purposes of disclosures of changes in those beginning and ending balances reported in the statement of financial position.
6. Decided to remove the requirement to disclose information about the effect of the change in accounting in the fiscal year in which the final Statement is initially applied to financial instruments subject to limited retrospective application. The transition adjustment should be determined in a single step based on the difference between the carrying amount and the fair value of those instruments at the date the final Statement is initially applied and recognized as a cumulative-effect adjustment to the opening balance of retained earnings for that fiscal year.

Issuance of a final Statement is pending, subject to the Board's deliberations in its related FASB Staff Position (FSP) project to consider practice issues relating to the application of the fair value measurement objective under particular existing pronouncements.

## Objective of Meeting

The purpose of the meeting was for the Board to address issues raised by external reviewers on a draft of the final FASB Statement on fair value measurements. The objective of the meeting was met.

## Matters Discussed and Decisions Reached

### Definition of Fair Value

1. Ms. MacDonald explained that some external reviewers of the draft Statement suggested that the Board expand the definition of fair value to incorporate the relevant terms referred to within the draft Statement, for example, the reference to an orderly transaction and the principal (most advantageous) market concept. She stated that the staff recommends that the Board retain the proposed definition to more clearly convey the exit price objective encompassed within the definition, revised, however, to refer to an **orderly** transaction between market participants at the measurement date.

2. All Board members agreed with that staff recommendation.

### Unobservable Inputs and Undue Cost and Effort

3. Ms. MacDonald referred to some reviewer concerns about measurements using market participant assumptions in the absence of observable inputs. She asked the Board whether, in response, the draft Statement should be revised to incorporate the undue cost and effort criterion in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, previously incorporated in the FASB Exposure Draft, *Fair Value Measurements*. In that case, the related guidance would clarify that in the

absence of observable inputs, a fair value measurement should be determined using unobservable inputs reflecting the reporting entity's own assumptions about the assumptions that market participants would use (including assumptions about risk) in pricing the asset or liability developed based on the best information available in the circumstances. The reporting entity's own data may be used provided that there are no contrary data indicating that market participants would use different assumptions. She emphasized that even if unobservable inputs are used to measure fair value, the reporting entity would need to consider an adjustment for risk (for example, risk related to the valuation techniques and/or the inputs to those valuation techniques).

4. All Board members agreed to include that undue cost and effort criterion in the final Statement on fair value measurement.

5. Mr. Trott stated that the undue cost and effort criterion seems to be intuitive but noted that inclusion of the criterion would not impact the final Statement. Mr. Young agreed with Mr. Trott adding that the inclusion of the undue cost and effort criterion should not be needed (as it is redundant).

6. Ms. Seidman emphasized that the inclusion of the undue cost and effort criterion would still require an entity to include a risk premium in its fair value measurements. She further stated that the inclusion of the undue cost and effort criterion does not undermine the Board's previous decision to remove the minimum reliability threshold from EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities." Thus, an entity is required to adjust for the risk associated with unobservable inputs regardless of the difficulty in determining the appropriate risk adjustment.

7. Ms. Schipper stated that in the event an entity uses unobservable inputs in determining fair value, that entity must consider assumptions about the amount market participants would require in making that determination even if that information is based on the entity's own data. Thus, an entity would use its own

assessment for the risk premium unless there evidence that a market participant would use a different amount. Mr. Trott noted that in many cases an entity should be able to observe a risk premium in similar market transactions.

**Inputs Based on Bid and Ask Prices**

8. Ms. MacDonald explained new concerns raised by some external reviewers about the guidance for using bid and ask prices to measure fair value; specifically, the requirement to use the same price to measure the fair value of offsetting long and short positions in the same instrument. In that regard, the reviewers referred to differences between that guidance in the draft Statement and the related guidance in IAS 39, *Financial Instruments: Recognition and Measurement*, noting that the guidance in the draft Statement could result in a significant change to practice for some entities. Ms. MacDonald stated that it was not the Board's intent to change practice. Rather, in its redeliberations of the more prescriptive guidance for using bid and ask prices to measure fair value previously included in the Exposure Draft, the Board decided that having set out the fair value measurement principle, the draft Statement should allow for judgment in applying that principle. Consistent with that earlier decision, the staff recommends that the Board remove that incremental measurement guidance from the draft Statement.

9. All Board members agreed with that staff recommendation.

**Disclosures**

10. Ms. MacDonald noted that some external reviewers referred to the need for more comprehensive disclosures about fair value measurements, including the need for qualitative disclosures about the inputs used for all (or some) fair value measurements, in particular, Level 3 fair value measurements. She also noted that other disclosures included (a) some that were previously considered and rejected by the Board (for example, disclosures about unrealized gains or losses at initial recognition in situations in which a fair value measurement is different from a transaction price) and (b) others that go beyond the disclosure

objectives set out in the draft Statement. Ms. MacDonald explained that the external reviewers emphasized the need for the Board to consider those disclosures (either in the fair value project or other related projects).

11. Ms. MacDonald stated that the staff recommends that any new disclosures be limited to disclosures about the inputs used for nonrecurring fair value measurements within Level 3, considering the use of unobservable inputs developed based on an entity's own data for those measurements (principally, for nonfinancial assets/liabilities).

12. All Board members agreed with that staff recommendation.

**Recurring Level 3 Fair Value Measurements**

13. Ms. MacDonald explained that some external reviewers expressed concerns about the requirement to disclose information about changes in beginning and ending balances of recurring Level 3 fair value measurements for derivatives separately for asset and liability positions (gross) as presented in the statement of financial position. In particular, they indicated that because there could be an asset position in one reporting period and a liability position in the next reporting period, gross presentation would not be cost beneficial. They encouraged the Board to allow net presentation for derivatives. Ms. MacDonald stated that the staff prefers gross presentation, but believes that issue would be more effectively considered in the context of all derivatives disclosures in the derivatives disclosures project. In the interim, the staff recommends that the Board allow net presentation for derivatives for purposes of the disclosure required in the draft Statement.

14. All Board members agreed with that staff recommendation.

**Transition**

15. Ms. MacDonald explained that some external reviewers expressed concern regarding the cost-effectiveness of the disclosures required for instruments subject to limited retrospective transition approach (specifically instruments that had a deferred gain or loss at the inception of the instrument under Issue 02-3 or other instruments that use the guidance in Issue 02-3). Ms. MacDonald noted that the Board previously decided to require incremental disclosures in the year that the final Statement is adopted and in the interim periods of that year. Ms. MacDonald stated that the staff recommends that the Board remove those disclosure requirements from the draft Statement, noting that similar disclosures are not required by other recently issued Statements that require limited retrospective transition. Ms. MacDonald stated that the staff also recommends the Board clarify that the transition adjustment should be determined in a single step based on the difference between the carrying amount and the fair value of those instruments at the date the final Statement is initially applied and recognized as a cumulative-effect adjustment to the opening balance of retained earnings for that fiscal year.

16. All Board members agreed with that staff recommendation.

17. The Board decided to postpone the issuance of the final Statement pending the guidance to be included in the proposed FSP.

**Follow-up Items:**

18. None.

**General Announcements:**

19. None.