MINUTES

To:	FASB Board Members
From:	FAS 157 Team (Clark x443)
Subject:	Minutes of the February 25, 2009 Board Meeting: Proposed FSP FAS 157-c, *Measuring Liabilities under FASB Statement No. 157*
Date:	March 18, 2008
cc:	FASB: Golden, Bielstein, Proestakes, Stoklosa, Mechanick, Anderson, Glotzer, Chookaszian, Posta, Lott, C. Smith, Gabriele, Inzano, Maples, Sutay, Mills, FASB Intranet, Clark, Martin, Klimek, Allen, Lapolla; GASB: Reese, Schermann; IASB: Leisenring

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, Interpretation, or FASB Staff Position.

Topic:	Proposed FASB Staff Position (FSP) FAS 157-c, *Measuring Liabilities under FASB Statement No. 157*
Basis for Discussion:	Memorandum No. 3
Length of Discussion:	9:30 a.m. - 10:30 a.m.
Attendance:	
Board members present:	FASB: Herz, Linsmeier, Seidman, Siegel, and Smith IASB: Leisenring
Board members participating by phone:	None
Board members absent:	None

Staff in charge of topic: FASB: Anderson and Maples

Other staff at Board table: FASB: Golden, Stoklosa, Clark

Summary of Decisions Reached

The Board discussed potential revisions to the scope, guidance, and effective date of proposed FSP FAS 157-c, *Measuring Liabilities under FASB Statement No. 157*.

The Board decided that the final FSP will apply to the fair value measurement of liabilities under FASB Statement No. 157, *Fair Value Measurements*.

The Board decided that the final FSP will require that practitioners generally use the same approach to valuing a liability under Statement 157 as used for an asset. The exception is that restrictions on the transfer of a liability will not affect the fair value measurement of that liability, whereas restrictions on an asset are considered when determining the fair value of that asset.

The Board agreed that the quoted price for the identical liability when traded as an asset in an active market (that is, the fair value of the asset would be categorized as a Level 1 measurement within the fair value hierarchy) will be the fair value for that liability. However, as with any input into a fair value measurement, an entity would need to determine whether an input (for example, the quoted price for the identical liability when traded as an asset in an active market) should be adjusted for factors specific to the liability and the asset. Some circumstances where an entity should consider whether adjustments are required to the quoted price for the asset to determine the fair value of the liability include:

1. The quoted price for the asset reflects a distressed sale at the measurement date.
2. The price of the asset includes the effect of a restriction preventing the transfer of the asset.
3. The unit of account for the asset is not the same as the liability (for example the quoted price for the asset includes the effect of a credit enhancement).

In those circumstances, to determine the fair value of the liability, it would be appropriate for practitioners to use

1. The quoted price of the liability when traded as an asset and adjust that price for factors specific to the asset;
2. An entry price notion that considers the principles of Statement 157; or
3. Another valuation technique, such as a present value technique.

If the resulting fair value measurement of the liability is based on the liability when traded as an asset, the level in the fair value hierarchy into which the fair value measurement of the liability would be categorized would be based on the level into which the asset is categorized.

The Board decided to reexpose the proposed FSP for an additional 30-day period. The proposed guidance would be effective for periods beginning after July 1, 2009.

Objective of Meeting

The objectives of this meeting were to (a) provide the Board with alternative views to address constituents' concerns regarding the fair value measurement of liabilities and (b) provide clarification on the application of FASB Statement No. 157, *Fair Value Measurements*, to liabilities. The objectives were met.

Matters Discussed and Decisions Reached

1. Mr. Maples began the meeting by summarizing the history of the project. He stated that the purpose of the meeting was to (a) provide the Board with alternative views to address constituents concerns and (b) clarify the application of FASB Statement No. 157, *Fair Value Measurements*, to liabilities. He emphasized that the staff does not address whether fair value is the appropriate measurement attribute for a liability as doing so is outside the scope of the project.

2. Mr. Maples stated that of the five views outlined in the February 25, 2009, handout for proposed FSP FAS 157-c, the Board had previously discussed four (View A and Views C-E). He added that the only new view included in the handout is View B.

GUIDANCE

3. Mr. Maples stated that the staff recommends View B because it satisfies the objective of clarifying the application of Statement 157 to liabilities. In addition, View B eliminates the confusion caused by legal restrictions preventing the transfer of the liability, creates a consistent measurement framework that can be applied to both financial and nonfinancial liabilities, and establishes a benchmark by which the entity's advantages and disadvantages relative to the market can be assessed. Furthermore, the staff considers View B consistent with the transfer notion of Statement 157.

4. **Board vote:** Board members agreed to articulate a principle that encompasses both View A and View B. Such a principle is summarized in the summary of decisions reached section of these minutes.

5. **Board comments:** Mr. Linsmeier asked the staff for an update on the activities of the International Accounting Standards Board (IASB) related to the fair value measurement of liabilities. Mr. Anderson stated that the IASB addressed the issue at its February 2009 meeting. He added that the minutes from that meeting suggest that several board members feel that the fair

value of liability should always equal the fair value of the identical asset. Mr. Smith asked the staff if the IASB had discussed the fair value measurement of a liability in the context of a specific type of market. Mr. Anderson stated that he was not sure.

6. Mr. Leisenring stated that two IASB Board members suggest that the fair value of a liability is always the fair value of the identical asset. However, other IASB Board members suggested that this principal is most often true; it will not be so in all circumstances.

7. Ms Seidman stated that the IASB Board members concluded that the relevant guidance would state that the approach used to valuing an asset will be the same as that used to value a liability. Mr. Leisenring added that the IASB also would address when the process would differ and why.

8. Mr. Smith asked the staff to explain View B. Mr. Maples stated there are two principles that the staff wanted to emphasis in View B:

   a. The staff wanted to articulate a principle that would state that a restriction on the transfer of a liability is present when the parties enter into the liability. As a result, there should be no additional adjustments for restrictions on transfer.

   b. The staff wanted to articulate that the process of determining the fair value of a liability is very similar to that used to determine the fair value of an asset.

9. Mr. Golden stated that the exception (to the idea that the valuation process used for assets and liabilities is generally the same) is that the fair value measurement of an asset would take into account restrictions affecting the transfer of that asset whereas the fair value measurement of a liability would not take into account restrictions affecting the transfer of that liability.

10. Mr. Maples stated that the difference between a restriction on an asset and a liability is that, generally, all liabilities have restrictions on transfer. Those liabilities that do not have a restriction on transfer do not typically have many market participants seeking purchase. However, if two assets are identical with the exception that one has a restriction on transfer and the other does not, the asset with a restriction on transfer will generally be valued at lesser amount.

11. Mr. Smith asked if an issuer that issued a debt instrument would look to the price of the debt instrument traded as an asset if it were traded as an asset in an inactive market. Mr. Maples stated that he would agree with that conclusion. However, the issuer would need to consider whether

characteristics of the asset, like guarantees, bid-ask spreads, or restrictions on transfer, would affect the fair value of a liability differently (if at all).

12. Mr. Siegel stated that he interpreted View A to state that the price of the liability will always equal the price of the identical asset. No other considerations are necessary. However, View B would allow an entity to view the price of the identical asset as an input into the valuation of the liability and make other considerations in determining the fair value of the liability.

13. Mr. Smith asked the staff if using an entry price notion to value a liability with a restriction on transfer would be appropriate if the liability were not traded as an asset in an active market. Mr. Maples stated that the staff did not try to proscribe a model to address such situations. Mr. Smith stated that he rejects View B because it is overly-complicated and, as such, not operational in practice.

14. Mr. Maples added that given the situation Mr. Smith presented, he agreed with his conclusions. However, he added that in previous meetings the staff had proposed an entry price model and each time that model was proposed, the staff received feedback that the model was not consistent with Statement 157. Mr. Smith stated that the staff memorandum assumed away the real issue—that is, what the appropriate measurement attribute of a liability should be.

15. Mr. Maples stated that the proposed model would allow the use of an entry price, but the model would also require consideration of relevant facts, such as the fact that the entry price may be in a different principal market than an exit price or that the entry price does not include assumptions that a market participant would consider in pricing the liability. He added, for example, that the valuation of an asset retirement obligation (ARO) upon assumption of the liability using an entry price does not include a profit element; but, if the ARO was transferred to a market participant, that market participant would require a profit from assuming the liability so an entry price in that case may not represent fair value. He added that the difficulty in proscribing a model is that one model will not always provide the correct answer. So the staff tried to embody in the guidance the idea that (a) because legal restrictions preventing the transfer of a liability are reflected in the transaction price received by the reporting entity upon initial recognition of the liability, the fair value measurement of a liability should not include any additional input or adjustment to existing inputs (premium or discount) relating to the absence of market participants for the transfer of the liability or existence of legal restrictions preventing the

transfer of the liability, and (b) when valuing a liability, one should follow the principles of Statement 157.

16. Mr. Smith asked the staff whether an entry price notion would be appropriate in most or all instances when one is valuing a liability that results from an entity borrowing money from another. Mr. Maples agreed that in most cases that would be appropriate.

17. Mr. Linsmeier stated that what he read and what he would support wholly is the following: If there is an actively traded market for the identical asset, that price is a Level 1 measurement and should be used. If there is not an actively traded market for the identical asset, then one moves to a Level 2 or Level 3 fair value measurement. The starting point for that measurement could be: (a) the traded price for the identical asset, (b) the entry price for the liability, or (c) a present value calculation. However, one would need to then consider whether the inputs to the measurement need adjustment for factors other than a restriction on transfer. He added that the guidance would need to explain why the restriction would be ignored for a liability, but not for an asset. He asked the staff if his remarks were an appropriate articulation of the staff's recommendation.

18. Mr. Maples stated that he agreed with Mr. Linsmeier's articulation. However, he added that the staff's proposed model does not say that the quoted price for the actively traded identical asset is a Level 1 measurement; the staff's proposed model suggests that it is a Level 2 measurement.

19. Mr. Leisenring stated that they may not want to call the measurement a Level 1 measurement because the measurement is not based on a quoted price for the liability but rather on the asset. However, he stated that it would be considered an unadjusted Level 2 measurement.

20. Ms. Seidman asked the staff why they would press to call that measurement a Level 2 measurement. She added that in determining the fair value measurement of the liability, one is finding the price of the identical asset, the value of identical cash flows, in an active market. Mr. Golden stated that the measurement would not technically be a Level 1 measurement because it is not the liability that is actively traded, it is the asset.

21. Ms. Seidman stated that it is important that the guidance states that a liability restriction relates to performance and as such, is inherent in any liability; recognition is not given to the restriction. Mr. Linsmeier added that there is market evidence that demonstrates that there are not large spreads on original trades involving liabilities with restrictions on transfer.

22. Ms. Seidman stated that her concern with automatically viewing the liability differently from the asset (as not being a Level 1 measurement) is that entities that are in and out of the market long and short frequently would have fair value measurements moving in and out of fair value levels unnecessarily.

23. Mr. Linsmeier stated that if there is a market price for the "identical" asset, one must consider (a) whether the asset price is reflective of a distressed transaction in an active or inactive market and (b) whether the price of the asset reflects a restriction on the transfer of that asset. If the answer to either consideration is yes, one must consider adjusting the price of the identical asset. Mr. Leisenring added that one does not know if the asset is truly identical to the liability until those questions are answered.

24. Mr. Golden stated that if one were to look at an actively-traded bond and value the obligation based on market price, what is being measured (the liability) is not actively traded; it is the bond held as an asset that is actively traded. So, the resulting fair value measurement technically could not be a Level 1 measurement. He asked Board members if they believed the words of Statement 157 would need to be amended.

25. Ms. Seidman stated that Statement 157 would not need to be amended. Mr. Herz asked if the impact of calling the resulting measurement a Level 2 measurement would be only on disclosure. Mr. Smith stated that Ms. Seidman raised the concern that the transfers out of the Levels would have to be disclosed.

26. Mr. Herz stated that he agreed with Ms. Seidman. The guidance should state that for purposes of disclosure, the fair value measurement resulting from using the price of the identical asset in an active market is a Level 1 measurement. If adjustments were made to the price of the identical asset, the resultant measurement would be a Level 2 measurement.

27. Mr. Siegel stated that View B did a good job of discussing the fact that restrictions on the transfer of a liability are considered on the day the liability is assumed. The restrictions do not subsequently change. However, he stated that it is unclear as to whether View B answers the question of whether one can use an entry price notion if there is not an identical asset traded in an active market.

28. Mr. Smith stated that View B is very workable as long as it is explained more wholesomely as discussed during the Board meeting. He added that View B would lead one to the correct conclusion. However, the View would need to be explained better.

29. Mr. Siegel stated that he viewed the Board's conclusion as being a mix of View B and View A. Other Board members agreed.

30. Mr. Golden asked Board members if they had concluded the following: The way one determines the fair value of a liability is in reference to asset. Restrictions on transfer are ignored for a liability, but not for an asset. If the fair value measurement of the identical asset is a Level 1 measurement, then that measurement would be used for the liability. If the fair value measurement of the "identical" asset is a Level 2 or Level 3 measurement, then the principles in Statement 157 should be used to determine the fair value of the liability. He asked Board members if they agreed. Board members agreed.

31. Mr. Herz suggested that the final FSP include 3 or 4 educational examples that demonstrate the valuation of the liability in circumstances where: (a) the liability is traded as an "identical" asset in an active market, (b) the liability is traded as a "slightly different" asset in an active market, and (c) there is no actively traded "identical" asset for the liability.

32. Mr. Maples asked Board members to clarify again whether the price of the identical asset would be considered a Level 1 or Level 2 measurement. He added that he is concerned with calling that measurement a Level 1 measurement because the staff has not yet considered what consideration (other than restrictions) would affect the fair value measurement of a liability and asset differently. Mr. Herz stated that for purposes of disclosure the measurement would be a Level 1 measurement, although he understands that technically it would be a Level 2 measurement. Mr. Linsmeier agreed.

33. Mr. Golden stated that technically when valuing a liability using an asset it would be Level 2. He added that an explanation of why that is the case is not all that important because one bases the measurement of the liability on the asset and the hierarchy level of the resultant liability measurement is thus driven off of the hierarchy level of the fair value measurement of the asset. However, if the asset is not "identical" (excluding restrictions on transfer), the liability measurement would move to Level 2 or Level 3.

34. Mr. Maples asked Board members to clarify whether the fair value measurement of a liability that results from using the price of the identical asset in an actively traded market would be a Level 1 measurement or a Level 2 measurement. Mr. Herz stated that the fair value measurement that results from using the price of the identical asset in an actively traded market,

is such exists, is technically a Level 2 measurement, but will be considered a Level 1 measurement for purposes of determining disclosure requirements.

35. Mr. Maples expressed concern that stating that the fair value measurement that results from using the price of the identical asset in an actively traded market, if such exists, is technically a Level 2 measurement, but will be considered a Level 1 measurement for purposes of determining what disclosures are required would create additional complexity. Ms. Seidman and Mr. Golden stated that guidance should state that the resultant measurement is a Level 1 measurement which would avoid the concern raised by Mr. Maples. Ms. Seidman added that the guidance must state such in the standards section and include the explanation of why the resultant measurement is considered a Level 1 measurement elsewhere.

SCOPE

36. Mr. Maples stated that one of issues discussed with constituents related to a potential revision to the scope of proposed FSP which would expand the scope to include assets with legal restrictions on transfer. The staff recommended that the scope of the proposed FSP be limited to liabilities as follows:

> The guidance in this FSP applies to the fair value of liabilities under Statement 157.

37. **Board vote:** All Board members agreed.

38. **Board comments:** Mr. Linsmeier emphasized the need for the guidance to communicate clearly why assets with restrictions and liabilities with restrictions are valued differently with respect to those restrictions. Ms. Seidman added that such must be done in the basis for conclusions (or elsewhere) and not in the standards section.

DUE PROCESS, EFFECTIVE DATE AND TRANSITION

39. The staff recommended that the proposed FSP be exposed for a period of 30 days. The staff also recommended that the proposed FSP be effective for the first period (including interim periods) beginning after issuance with earlier application of the provisions of the proposed FSP permitted. Revisions resulting from a change in the valuation technique or its application should be included in changes in the fair value in the period of adoption.

40. **Board vote:** All Board members agreed.

41. **Board comments:** Mr. Herz asked the staff what other documents are expected to be issued or have comment letter deadlines at or near the same time. Mr. Golden stated that April is the deadline for first quarter-reporting. In addition, (a) the other guidance related to fair value measurements will be issued around the same time and (b) the comment letter deadline for the leases, revenue recognition, and financial statement presentation projects also occur near the same time. He added that if the Board desired to have the guidance in proposed FSP FAS 157-c effective by July 1, 2009, the Board would need to limit the exposure period to thirty days.

42. Mr. Herz asked the staff if practitioners were known to calculate the fair value of a liability and then adjust that calculation for a restriction on transfer of that liability. Mr. Maples stated that he is not sure, but that constituents suggested that they were applying the guidance in the proposed FSP (as previously exposed). He added that the feedback received from constituents also suggested that the Board should issue the proposed FSP to clarify that current practice is correct. The fact that the proposed FSP addresses nonfinancial liabilities is also helpful.

<u>Follow-up Items</u>

None.

<u>General Announcements</u>

None.