

September 27, 2006
Vol. 13, Issue 12

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FASB Issues Standard on Measuring Fair Value

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Introduction

While not officially recognized by the FASB as the year of fair value, the year 2006 may be regarded by many of the FASB's constituents as a bellwether for fair value in financial statements. Prior to the recent issuance of FASB Statement No. 157, *Fair Value Measurements*, 2006 witnessed three earlier pronouncements featuring fair value.¹ Look for another in the fourth quarter when the Board plans to issue a final Statement² giving companies a broad option to carry almost any financial asset or financial liability at fair value through earnings.

While most accounting pronouncements that involve fair value focus on **what** to measure at fair value, Statement 157 focuses on **how** to measure fair value. Dispersed throughout current GAAP are inconsistent definitions of fair value and only limited guidance on application. Statement 157 remedies the situation by providing **"one-stop shopping" for the definition of fair value and related measurement guidance**. In other words, Statement 157 does not introduce any new requirements mandating the use of fair value; instead, it unifies the meaning of fair value and adds important disclosures. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 — for example, January 1, 2008, for a calendar year-end entity.

Highlights of the Statement

Highlights of Statement 157 include the following:

- A new definition of fair value.
- A fair value hierarchy used to classify the source of information used in fair value measurements (i.e., market based or non-market based).
- New disclosures of assets and liabilities measured at fair value based on their level in the hierarchy.
- A modification of the long-standing accounting presumption that the transaction price of an asset or liability equals its initial fair value.
- Numerous other provisions discussed in the Appendix below, along with questions and answers related to the application of Statement 157.

¹ See FASB Statements No. 155, *Accounting for Certain Hybrid Financial Instruments*, and No. 156, *Accounting for Servicing of Financial Assets*, and FASB Staff Position No. FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors."

² For additional information, see proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*.

Scope

Except as noted below, Statement 157 must be applied to any asset or liability that is measured at fair value under current GAAP. Appendix D of Statement 157 lists 67 APB and FASB pronouncements that refer to fair value.³ The Statement will likely also apply to future accounting pronouncements requiring fair value.

Unaffected by the Statement are measurements that are (1) related to share-based payments,⁴ (2) based on (or that otherwise use) vendor-specific objective evidence of fair value,⁵ and (3) related to inventory.⁶

New Definition of Fair Value

Statement 157 defines “fair value” as:

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.

While the words may have a similar ring to past definitions, there are some key differences. First, the definition is based on an **exit price** (for an asset, the price at which it would be sold) rather than an entry price (for an asset, the price at which it would be bought), regardless of whether the entity plans to hold or sell the asset.

A second key definitional point is that Statement 157 emphasizes that fair value is **market based** rather than entity specific; fair values must rest on assumptions that market participants would use in pricing the asset or liability. Thus, the optimism that often characterizes an asset owner must be replaced with the skepticism that typically characterizes a risk averse buyer.

Example

Company X (X) is testing land and a manufacturing facility to be held and used for the purposes of a Statement 144⁷ impairment test. In testing the assets for recoverability under Step 1 of the impairment test, X projects the cash flows it expects to realize from operating the assets.⁸ Step 1 of the test indicates that the carrying value of the assets is not recoverable. Company X then discounts the same cash flows (under an income approach) for Step 2 of the test and arrives at a value of \$40 million. Simply using cash flows based on X’s intended use of the facility may not comply with Statement 157’s new definition of fair value. The new definition reminds entities that, even though they may intend to use the land and manufacturing facility for the foreseeable future, they must consider market-participant-based information, and the \$40 million may not represent fair value. For example, if recent sales of comparable facilities in the area have closed at a significantly lower amount, say \$30 million, the fair value of the land and building must consider such market-based information.

Fair Value Hierarchy

Statement 157’s fair value hierarchy underpins the standard. The hierarchy ranks the quality and reliability of information used to determine fair values — quoted prices are the most reliable valuation inputs, whereas model values that include inputs based on unobservable data are the least reliable. The table below provides a description of the levels in the hierarchy and examples:

³ FASB Statements No. 115, 133, 141, 142, 143, 144, 146, 155, and 156, to name a few.

⁴ For example, FASB Statement No. 123(R), *Share-Based Payment*.

⁵ For example, AICPA Statement of Position 97-2, *Software Revenue Recognition* (as modified).

⁶ Accounted for in accordance with Accounting Research Bulletin No. 43, Chapter 4, “Inventory Pricing.”

⁷ FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

⁸ Statement 157 does not change the requirement in Statement 144 for a company to incorporate its own assumptions about its use of an asset group (without consideration of market participants) for the purposes of determining whether the asset group is recoverable under Step 1 of the impairment test for assets held and used.

Level and “Inputs” (Information Used in Determining Fair Value)	Examples
Level 1 — Quoted market prices for <i>identical</i> assets or liabilities in <i>active</i> markets	<ul style="list-style-type: none"> • Company A common stock traded and quoted on the New York Stock Exchange.
Level 2 — Observable market-based inputs, other than Level 1 quoted prices (or unobservable inputs that are corroborated by market data)	<ul style="list-style-type: none"> • Company Z (Z) common stock traded and quoted only on an inactive market in an emerging country. • A privately placed bond of Z whose value is derived from a similar Z bond that is publicly traded. • An over-the-counter interest rate swap, valued based on a model whose inputs are observable LIBOR forward interest rate curves.
Level 3 — Unobservable inputs (that are not corroborated by observable market data)	<ul style="list-style-type: none"> • A long-dated commodity swap whose forward price curve, used in a valuation model, is not directly observable or correlated with observable market data. • Shares of a privately held company whose value is based on projected cash flows.

The hierarchy requires users to maximize market-based information, and it provides a basis for Statement 157’s new disclosures (which, in part, bucket assets and liabilities accounted for at fair value by the level in the hierarchy under which they have been valued). In short, to value an item, start at Level 1, and move down the hierarchy if Level 1 information does not exist.

Disclosures

The new disclosures shed light on the relative reliability of fair value measurements. Statement 157 requires separate disclosures of items that are measured at fair value on a recurring basis (e.g., an investment portfolio) versus items that are measured at fair value on a nonrecurring basis (e.g., an impaired asset). The following briefly summarizes the major disclosures required at each annual and interim balance sheet date:

- For items that are measured on a non-recurring basis at fair value:
 - o A separate table for assets and for liabilities that displays the balance sheet fair value carrying amount of major categories of assets and of liabilities is required. Within each table, the assets and liabilities measured at fair value in each major category are separated into the level of the hierarchy on which fair value is based. The table also includes total gains and losses recognized for each major category (see [Question 1](#) below).
- For items that are measured on a recurring basis at fair value:
 - o Tables similar to those required for non-recurring items (see above), and
 - o Additional information regarding fair values based on Level 3 (unobservable) inputs, including a rollforward analysis of fair value balance sheet amounts and disclosure of the unrealized gains and losses for Level 3 items held at the reporting date is required (see [Question 1](#) below).

Editor’s Note: The fair value of an asset or liability is often based on information from more than one level of the hierarchy. The classification of fair value for disclosure purposes depends on the lowest level input with significant effect. For example, if a particular measurement contains both Level 2 and Level 3 inputs and both have a significant effect, then the measurement falls in Level 3.

Modification of the Transaction Price Presumption

Under current GAAP, the transaction or entry price (for example, the price paid for an asset) is presumed to be fair value absent persuasive evidence to the contrary when the item is initially recognized. Because an exit price is not necessarily equal to the transaction price, Statement 157 does away with that presumption. Instead, entities should consider whether certain factors (see Question 5), when present, **might** indicate that the transaction price does not represent fair value. When that's the case, a separate determination of fair value needs to be made.

For major derivative dealers, the FASB's approach represents a significant change from today's GAAP. Heretofore, traders have postponed recognizing gains and losses at the time they initially record certain highly complex financial instruments⁹ because to do so would represent a departure from the transaction price presumption. See [Question 4](#) below for an example and more details.

Effective Date and Transition

The Statement is effective for financial statements issued in fiscal years beginning after November 15, 2007. For example, a company with a calendar year end is required to apply Statement 157 in its financial statements at the beginning of the quarter ended March 31, 2008. Early adoption is permitted if the entity has not yet issued financial statements for that fiscal year (including any interim periods).

Generally, companies will apply the provisions of the standard prospectively (see [Question 11](#) below for certain situations whereby transition is via a cumulative-effect adjustment).

Final Thoughts

While 2006 might be the bellwether year for fair value, future accounting developments can't be overlooked. In 2007, the FASB plans to issue a major change to accounting for business combinations with an expanded emphasis on fair value. As mentioned above, the FASB is scheduled later this year to issue a standard permitting, but not requiring, companies to value virtually any financial instrument at fair value. After that, the FASB will begin to consider whether entities should have the option to account for certain **non-financial assets and liabilities** at fair value.

Statement 157 represents the FASB's most current leaning on the age-old trade off between reliability and relevance of financial information. Statement 157 reflects the FASB's studied conclusion that investors and creditors find fair value measurement relevant, even in the absence of solid market data. As a result of the trade off now favoring relevance, financial statement users need to be apprised of the quality of the information through the meaningful and transparent disclosures required by the new standard.

On October 23, 2006, we will host a *Dbriefs* webcast on Fair Value Measurements. Registration for this webcast will be available soon. (Information about *Dbriefs* webcasts can be found on the back page of this issue.)

⁹ Statement 157 nullifies footnote 3 of 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," and paragraph 4(d) of Statement 155.

Appendix

Questions and Answers Related to Statement 157

Click a question below to jump to its related Q&A.

1. What disclosures are required by Statement 157?
2. What should an entity do when market-based information is not available?
3. Under Statement 157, should fair value be adjusted for transaction costs?
4. In a derivative transaction, can a securities dealer and its retail customer/counterparty conclude that the derivative has different fair values for each?
5. Question 4 illustrates one instance in which the transaction price was not considered representative of fair value (the transaction occurred in a market other than the principal market for one of the parties in the trade). Are there other instances?
6. Should an investor or trader reduce the fair value of a very large investment because the size of the position will affect its liquidity and, hence, its value?
7. If only bid and ask prices are quoted, which should be used to determine fair value?
8. How should derivative dealers apply Statement 157 to pricing their derivative portfolios?
9. Do restrictions affect the fair value of an asset?
10. Does Statement 157 apply to liabilities?
11. When are the provisions of Statement 157 not applied on a prospective basis?

Questions and Answers Related to Statement 157

1. What disclosures are required by Statement 157?

Statement 157 imposes significant new disclosure requirements on the presentation of fair value information. The FASB concluded these disclosures are warranted because the standard establishes a new framework for fair value and because the disclosures “allow users of financial statements to assess the **relative reliability** of the [fair value] measurements.”

Tabular Information

The table below, reproduced from Statement 157, illustrates disclosures related to assets measured at fair value on a non-recurring basis. A table is also required for liabilities measured at fair value on a non-recurring basis, if any exist. Note that a similar (but not identical) set of disclosures should be made for assets and liabilities that are remeasured at fair value on a recurring basis.

Qualitative information (i.e., a description of the information used to develop the measurements, the valuation technique, and a discussion of any changes to valuation techniques) should accompany the table.

Description	Year Ended 12/31/XX	Fair Value Measurements Using			Total Gains (Losses)
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Long-lived assets held and used*	\$ 75		\$ 75		\$ (25)
Goodwill**	30			\$ 30	(35)
Long-lived assets held for sale***	26	\$ 26			(15)
					<u>\$ (75)</u>

* In accordance with the provisions of Statement 144, long-lived assets held and used with a carrying amount of \$100 million were written down to their fair value of \$75 million, resulting in an impairment charge of \$25 million, which was included in earnings for the period.

** In accordance with the provisions of Statement 142, goodwill with a carrying amount of \$65 million was written down to its implied fair value of \$30 million, resulting in an impairment charge of \$35 million, which was included in earnings for the period.

*** In accordance with the provisions of Statement 144, long-lived assets held for sale with a carrying amount of \$35 million were written down to their fair value of \$26 million, less cost to sell of \$6 million (or \$20 million), resulting in a loss of \$15 million, which was included in earnings for the period.

Additional Analysis of the Effect of Recurring Level 3 Measurements

For **recurring** fair value measurements based on **unobservable inputs** (Level 3), companies are required to roll forward beginning fair value amounts to the end of the period as is shown in the following example extracted from the standard. Remember, Level 3 valuations are those that are based on model inputs that cannot be observed in the market. The disclosure objective is to make readers understand (1) the extent of fair values in the financial statements (see the tables above) and (2) details of the impact of unobservable fair values on the entity's earnings (shown in the table below). An especially interesting disclosure is italicized in the table, displaying how much the unrealized change in value of Level 3 items contributed to earnings during the period.

(\$ in 000s)	Recurring Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Derivatives	Venture Capital Investments	Total
Beginning balance	\$ 14	\$ 11	\$ 25
Total gains or losses (realized/unrealized)			
Included in earnings (or changes in net assets)	11	(3)	8
Included in other comprehensive income	4		4
Purchases, issuances, and settlements	(7)	2	(5)
Transfers in and/or out of Level 3	(2)	—	(2)
Ending Balance*	<u>\$ 20</u>	<u>\$ 10</u>	<u>\$ 30</u>
<i>The amount of total gains or losses for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date</i>	<u>\$ 7</u>	<u>\$ 2</u>	<u>\$ 9</u>
(Note: For liabilities, a similar table should be presented.)			
Gains and losses (realized and unrealized) included in earnings (or changes in net assets) for the period (above) are reported in trading revenues and in other revenues as follows:			
	Trading Revenues	Other Revenues	
Total gains or losses included in earnings (or changes in net assets) for the period (above)	<u>\$ 11</u>	<u>\$ (3)</u>	
Change in unrealized gains or losses relating to assets still held at reporting date	<u>\$ 7</u>	<u>\$ 2</u>	
* Derivative assets and liabilities may be presented net for the purposes of this reconciliation.			

Editor's Note: Companies with significant amounts of recurring Level 3 measurements should study these disclosure requirements carefully to make sure that information systems are in place to capture the data.

2. What should an entity do when market-based information is not available?

When GAAP requires fair value, Statement 157 requires preparers to measure the item in accordance with its provisions even in the absence of market-based information. Typically, the measurement would be in Level 3 if a significant portion of the value is derived from unobservable inputs.

Statement 157 requires the use of market participant information when it is **reasonably available without undue cost and effort**. Even in the absence of market-based information, Statement 157 reminds preparers that they still must use a market-based perspective. When market-based information is not available, an entity should use its own assumptions about market participant assumptions.

It is important to note that **Statement 157 does not remove practicability exceptions that exist in other GAAP** (as listed in paragraph C21 of Statement 157). For example, APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, does not require fair value for nonmonetary transactions when fair value is not reasonably determinable.

3. Under Statement 157, should fair value be adjusted for transaction costs?

No. Transaction costs represent the **incremental direct costs to sell** the asset or transfer the liability (similar to costs to sell as defined in paragraph 35 of Statement 144). Transaction costs are not an attribute of the asset or liability; instead, they are specific to a transaction and will differ depending on how the reporting entity transacts. According to Statement 157, they should be accounted for in accordance with the provisions of other applicable accounting pronouncements.

Example

A long-lived asset classified as held for sale is measured at the lower of its carrying amount or fair value less **cost to sell**. Thus, if the asset is adjusted to reflect an impairment, the adjusted carrying amount will be (1) below the asset's fair value and (2) below the amount that is disclosed pursuant to Statement 157 (see [Question 1](#) above).

On the other hand, *transportation* costs sometimes are an element of fair value — when location is an attribute of the asset or liability (as might be the case for a commodity). Thus, the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

4. In a derivative transaction, can a securities dealer and its retail customer/counterparty conclude that the derivative has different fair values for each?

Yes. As illustrated in Example 7 (paragraph A27 of Statement 157), from the perspective of the dealer, the initial transaction price of the swap (typically zero) does not necessarily represent fair value from the dealer's perspective. Why? The dealer can take advantage of pricing differences between the dealer's *principal* market (the inter-dealer market) and the retail market in which the swap was transacted. Price differences between these markets indicate that, from the dealer's perspective, the zero transaction price is often less than fair value. On the other hand, because the retail customer is transacting in its principal market, the zero transaction price represents fair value to the retail counterparty.

5. **Question 4** above illustrates one instance in which the transaction price was not considered representative of fair value (the transaction occurred in a market other than the principal market for one of the parties in the trade). Are there other instances?

Yes. Statement 157 cites four instances, shown in the table below, that might indicate that the transaction price does not represent fair value.

Instance	Example
The transaction is between related parties.	A parent company purchases a portfolio of troubled loans from its wholly owned subsidiary. The price exceeds fair value because it incorporates a capital contribution from the parent to the subsidiary. Statement 157 contains guidance on related parties.
The transaction occurs under duress or the seller is forced to accept the price in the transaction because of urgency.	A hedge fund must immediately divest of non-marketable assets in an attempt to stave off a liquidity crisis.
The unit of account represented by the transaction is different from the unit of account for the asset or liability measured at fair value.	<ol style="list-style-type: none"> 1. A multiple element transaction where the asset or liability measured at fair value is only one of the elements in the transaction. 2. A transaction includes unstated rights and privileges that should be separately measured; e.g., the seller of real estate grants a non-interest bearing loan to the buyer. 3. The transaction price includes transaction costs.
The market in which the transaction occurs is different from the principal (or most advantageous) market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability.	See Question 4 above for an example. The <i>principal market</i> is the market in which the reporting entity would sell the asset or transfer a liability with the greatest volume and level of activity. In the absence of a principal market for the asset or liability, the entity should look to the most <i>advantageous market</i> (for example, the market that maximizes the amount received for an asset).

Editor's Note: While the factors (described above) may be helpful in determining whether the transaction price is fair value at initial recognition, they are not necessarily all inclusive.

6. **Should an investor or trader reduce the fair value of a very large investment because the size of the position will affect its liquidity and, hence, its value?**

It depends. Under Statement 157, when a quoted price in an **active** market exists, fair value is the product of the quoted price and the number of units (e.g., price per share multiplied by the number of shares) regardless of the size of an entity's position in the security. This puts an end to *block discounts* (i.e., price haircuts on very large positions in a single security) taken by many security dealers and some investment companies.

On the other hand, Statement 157 removes prohibitions in pre-existing GAAP that preclude liquidity haircuts for positions that trade in thin or **inactive** markets.

7. If only bid and ask prices are quoted, which should be used to determine fair value?

Statement 157 preserves the ability of securities brokers (and other types of entities) to use a price within the bid-ask spread that is most representative of fair value (consistently applied). The Statement does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

8. How should derivative dealers apply Statement 157 to pricing their derivative portfolios?

When Statement 157 was exposed for comment, it contained a reference to pricing conventions as described in paragraph BC100 of IAS 39, *Financial Instruments: Recognition and Measurement*. That paragraph describes the way most derivative dealers approach pricing their derivative portfolios and states in part:

The Board [the IASB] discussed whether the bid-ask spread should be applied to the net open position of a portfolio containing offsetting market risk positions, or to each instrument in the portfolio...The Board concluded that for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence may apply the bid or asking price to the net open position as appropriate. The Board believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread.

Statement 157 does not include any guidance regarding the accounting for offsetting positions because the standard provides for the selection of the price “most representative” of fair value in the bid ask spread (see [Question 7](#) above). Derivative dealers also need to ensure that they are selecting the appropriate unit of account when valuing their positions. Statement 157 directs companies to follow the provisions of other applicable accounting pronouncements in this regard.

9. Do restrictions affect the fair value of an asset?

It depends. Statement 157 clarifies that a fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset. This would usually be the case when the restriction is specific to (an attribute of) the asset and would transfer to market participants.

Example

Rule 144 of the Securities and Exchange Commission limits the sale of a security to *qualified* buyers, as defined. The restriction is an attribute of the security and would transfer to market participants. The effect of the restriction on value is the amount that a market participant would demand because of the inability to access a public market for the security for the specified period.

Example

Company A (A) has a common stock investment in Company B (B) and carries this investment at fair value. Because officers of A are directors of B, A cannot sell any of its common stock in B during the quiet period surrounding B’s periodic release of earnings. Other market participants, not being directors, would not face the restriction, thus it is not an attribute of the security and A should not adjust the fair value of the common stock of B for the effect of this restriction.

The standard’s guidance on restrictions applies regardless of when the restriction expires; thus, Statement 157 amends earlier standards (Statements 115 and 124)¹⁰ that limited adjustments only to those restrictions that extended beyond twelve months.

¹⁰ FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*.

10. Does Statement 157 apply to liabilities?

Yes, Statement 157 applies to liabilities and it includes a controversial provision that requires entities to take into account the effect of changes in their own credit standing when they measure one or more of their liabilities at fair value. Historically, fair value accounting has impacted assets more so than liabilities perhaps with the exception of some derivatives or in some disclosures required by FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*. However, companies will soon have the option to carry almost any financial liability at fair value with the FASB's forthcoming standard mentioned earlier. A company might choose to account for certain liabilities at fair value (1) to avoid the need for complex hedge accounting under Statement 133,¹¹ (2) to more meaningfully display the economics of its business, or (3) for other reasons.

The provision is controversial because of the non-intuitive impact of changes in an entity's credit standing. As an issuer's credit standing deteriorates, so does the fair value of its liabilities resulting in, everything else being equal, the issuer recognizing a gain. The opposite is true when the issuer's credit standing improves.

Editor's Note: To understand the phenomenon, consider the effect of changes in the investment value of a company's bonds when its credit standing changes. If the company experiences financial difficulty, the bonds decrease in value. Thus, the issuing company has to reduce the carrying amount of its bonds to capture that fair value change. The offset to that adjustment increases income. Another point that has often been cited to support the consideration of an entity's own credit in the valuation of its liabilities is the desired valuation symmetry between the party in the asset position (the lender) and the party in the liability position (the borrower). When a lender recognizes a decrease in fair value on its receivable, the borrower should recognize a corresponding decrease on its payable.

Many of the FASB's constituents objected to this result. Nevertheless, the Board concluded that a fair value measurement must include the effect of an entity's credit; otherwise, the measurement would not reflect the economic differences between liabilities issued by different entities.

Editor's Note: The Statement indicates that the effect of credit risk on the fair value of a liability may differ depending on the terms of credit enhancements related to the liability.

11. When are the provisions of Statement 157 not applied on a prospective basis?

In limited instances, the provisions of Statement 157 should be applied retrospectively at the beginning of the year of initial application via a cumulative-effect adjustment to opening retained earnings. Here are the limited instances:

- Securities traded in an active market to which a blockage factor had been applied (see [Question 6](#) above),
- Financial instruments, including derivatives and certain hybrid instruments with limitations on initial gains or losses under Issue 02-3 or Statement 155.

Example

Some years ago, a commodity trader entered into a long-dated, complex commodity derivative whose value significantly depends on Level 3 inputs. To comply with Issue 02-3, it recorded the derivative at fair value but deferred any profit upon initial recognition (subsequent changes in fair value have been recorded in income). At the beginning of the period that the commodity trader adopts Statement 157, the deferred profit should be eliminated and the fair value measurement of the derivative should be adjusted to conform to Statement 157 requirements, if necessary. The offset for both is recorded in retained earnings.

¹¹ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

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