

Heads Up

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Converging on Fair Value

FASB Proposes Guidance on Fair Value Measurement and Disclosure

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Yesterday, the FASB issued a proposed Accounting Standards Update (ASU), *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The proposed ASU is the result of a joint project between the FASB and IASB (the “boards”) to develop a single, converged fair value framework.¹

In October 2009, the boards reached an agreement to develop common fair value measurement and disclosure guidance. To meet this objective, the FASB agreed to consider comments the IASB received on its May 2009 ED and to amend ASC 820,² as necessary, on the basis of decisions reached during the boards’ joint redeliberations. The proposed ASU revises ASC 820 extensively; however, a number of the amendments are changes to the wording used to describe the principles and requirements and are not expected to change existing practice. (For more information about international convergence, see the [Convergence With IFRSs](#) section below.) Comments on the proposed ASU are due by September 7, 2010.

The proposed ASU retains the term “fair value” and continues to define it as an exit price notion, which is consistent with current guidance under ASC 820. The proposal, which would apply to any reporting entity that must measure or disclose the fair value of an asset, liability, or instrument classified in shareholders’ equity in the financial statements, does not introduce any new or revised requirements related to which items should be measured at fair value, nor does it affect the scope of ASC 820. However, entities affected by the FASB’s proposed ASU on accounting for financial instruments,³ or by its project on accounting for financial instruments with characteristics of equity, may need to measure more financial assets and financial liabilities at fair value. That is, the proposed amendments to other Codification topics may significantly expand the requirement to measure financial assets and financial liabilities at fair value.

Summary of Notable Provisions

The proposed ASU contains certain amendments that would change how the fair value measurement and disclosure guidance in ASC 820 is applied. For example, the proposal (1) clarifies the application of the highest-and-best-use and valuation-premise concepts, (2) permits an exception to fair value measurement principles when financial assets and financial liabilities that have offsetting positions in market risks or counterparty credit risk are managed on the basis of the net exposure to either of those risks, (3) includes guidance on measuring the fair value of an instrument classified in shareholders’ equity,

¹ Also yesterday, the IASB published ED/2010/7, *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*, which is a limited re-exposure of its May 2009 ED, IASB ED/2009/05, *Fair Value Measurement*. The new ED is identical to the proposed measurement uncertainty analysis disclosure in the FASB’s proposed ASU.

² For titles of *FASB Accounting Standards Codification* (ASC or “Codification”) references, see Deloitte’s “[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#).”

³ FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

and (4) eliminates the use of blockage factors at all levels within the fair value hierarchy. The proposal also requires measurement uncertainty disclosure in the form of a sensitivity analysis of unobservable inputs to reasonable alternative amounts for all Level 3 recurring fair value measurements unless a standard other than ASC 820 exempts such a disclosure. The sensitivity analysis disclosure would take into account the effect of the correlation between unobservable inputs when such correlation is relevant.

Highest-and-Best-Use and Valuation-Premise Concepts

The proposed ASU amends the guidance on the highest-and-best-use and valuation-premise concepts by clarifying that they only apply to measuring the fair value of nonfinancial assets. The boards concluded that financial assets and liabilities “do not have alternative uses.” Under the proposal, the highest and best use of a nonfinancial asset “is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity’s current use of an asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.” In determining the highest and best use, an entity must still contemplate whether the use of the asset is physically possible, legally permissible, and financially feasible. The proposed ASU discusses the meaning of these three terms.

The valuation premise used to determine the fair value of an asset is derived from the highest and best use of the nonfinancial asset. Under the proposal, the terms “in-exchange” and “in-use” are eliminated from ASC 820. These terms were used to describe the valuation-premise concept; however, the wording was often confusing to constituents. The proposal replaces the terms with descriptions of the concepts (i.e., valuing an asset on a stand-alone basis or in combination with other assets or with other assets and liabilities). The proposed ASU clarifies that when an asset’s highest and best use is on a stand-alone basis, an entity’s determination of fair value would reflect the assumption that market participants would use the asset on a stand-alone basis. When an asset’s highest and best use is in combination with other assets or with other assets and liabilities (i.e., with complementary assets and liabilities), an entity can assume that those complementary assets and liabilities are available to market participants.

Measuring the Fair Value of Financial Instruments That Are Managed Within a Portfolio

The proposed ASU provides an exception to fair value measurement when a reporting entity holds a group of financial assets and financial liabilities that have offsetting positions in market risks or counterparty credit risk that are managed on the basis of its net exposure to either of those risks. That is, when an entity has a portfolio in which the market risks (e.g., interest rate risk, currency risk, other price risks) being offset are substantially the same, “the reporting entity shall apply the price within the bid-ask spread that is most representative of fair value in the circumstances to the reporting entity’s net exposure to those market risks.” In addition, when there is a legally enforceable right to offset one or more financial assets and financial liabilities with a counterparty (e.g., master netting agreement), “the reporting entity shall include the effect of the reporting entity’s net exposure to the credit risk of that counterparty in the fair value measurement.” The proposed ASU further indicates:

If the reporting entity has a net short position (that is, the reporting entity owes the counterparty), the reporting entity shall apply such an adjustment on the basis of its own credit risk. If the reporting entity has a net long position (that is, the counterparty owes the reporting entity), the reporting entity shall apply an adjustment on the basis of the counterparty’s credit risk.

The proposal outlines the following criteria an entity must meet to use the exception:

- a. Manages the group of financial assets and financial liabilities on the basis of the reporting entity’s net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the reporting entity’s documented risk management or investment strategy

The proposed ASU amends the guidance on the highest-and-best-use and valuation-premise concepts by clarifying that they only apply to measuring the fair value of nonfinancial assets.

- b. Provides information on that basis about the group of financial assets and financial liabilities to the reporting entity's **management** (for example, the reporting entity's board of directors or chief executive officer)
- c. Manages the net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in a consistent manner from period to period
- d. Is required to or has elected to measure the financial assets and financial liabilities at fair value in the statement of financial position at each reporting date.

The ASU's proposed amendments are intended to reduce the current diversity in how entities interpret the fair value measurement guidance on financial instruments managed on a portfolio basis. Under U.S. GAAP, some entities apply the in-use valuation premise, while others apply the in-exchange valuation premise but apply a unit of valuation different from the unit of account. As discussed above, the valuation premise is no longer deemed relevant for financial assets and liabilities. Under IFRSs, reporting entities take into account the effects of offsetting market risks (as permitted under IAS 39)⁵ when measuring the fair value of financial instruments. The amendments in the proposed ASU "would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments."

The FASB indicated that the change in guidance is meant to reflect current practice and that it believes the "proposed amendments would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice." However, the board acknowledged that current practice could be affected for entities that tend to apply the in-use valuation premise more broadly (e.g., for financial assets that do not have offsetting positions in market risks or counterparty credit risk). For these entities, a different fair value measurement conclusion may result when the proposed amendments are applied.

The amendments in the proposed ASU "would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments."

Other Key Proposals

The proposal also amends guidance in the following areas:

- *Reference market* — The reference market for a fair value measurement is the principal (or, in the absence of a principal, most advantageous) market, provided that the entity has access to that market. The principal market is presumed to be the market in which the entity normally transacts. The proposal also indicates that an entity does not need to perform an exhaustive search for markets that might have more activity than the market in which the entity normally transacts but that the entity should consider information that is reasonably available.
- *Application to liabilities* — In the fair value measurement of a liability (whether financial or nonfinancial), it is assumed that the liability continues and the market participant transferee assumes responsibility for the obligation. The proposal requires that when using a present value technique to determine the fair value of a liability, a reporting entity take into consideration the future cash flows that a market participant would require as compensation for fulfilling and taking on the obligation. The guidance also provides examples of how that compensation may be reflected in the fair value of a liability.
- *Application to instruments classified in shareholders' equity* — No guidance currently exists on measuring the fair value of an instrument classified in shareholders' equity. The proposed ASU specifies that "the objective of a fair value measurement of an instrument classified in a reporting entity's shareholders' equity . . . is to estimate an exit price from the perspective of a market participant who holds the instrument as an asset at the measurement date."
- *Blockage factors* — The proposal clarifies that the application of a blockage factor is prohibited at all levels of the fair value hierarchy and notes that a "blockage factor is not relevant and, therefore, shall not be used when fair value is measured using a valuation technique that does not use a quoted price for the asset or liability (or similar assets or liabilities)." The boards indicated that the

⁵ IAS 39 *Financial Instruments: Recognition and Measurement*.

prohibition on using blockage factors is necessary because blockage is “specific to that reporting entity, not to the asset or liability.” Entities that currently apply a blockage factor to assets and liabilities categorized within Level 2 of the fair value hierarchy (that are measured on the basis of quoted prices) could be affected by these proposed amendments. The Board does not expect other Level 2 and Level 3 fair value measurements to be affected.

Disclosures

The proposed ASU requires entities to disclose information about measurement uncertainty in the form of a sensitivity analysis for recurring fair value measurements categorized in Level 3 of the fair value hierarchy unless another Codification topic specifies that such disclosure is not required (e.g., investments in unquoted equity instruments are not included in the scope of the disclosure requirement under the accounting for financial instruments project). Specifically, the amendment to ASC 820-10-50-2(f) states that an entity would disclose the following:

A measurement uncertainty analysis for fair value measurements categorized within Level 3 of the fair value hierarchy. If changing one or more of the unobservable inputs used in a fair value measurement to a different amount that could have reasonably been used in the circumstances **would have resulted in a significantly higher or lower fair value measurement**, a reporting entity shall disclose the effect of using those different amounts and how it calculated that effect. When preparing a measurement uncertainty analysis, a reporting entity shall not take into account unobservable inputs that are associated with remote scenarios. A reporting entity shall **take into account the effect of correlation between unobservable inputs** if such correlation is relevant when estimating the effect on the fair value measurement of using those different amounts. For that purpose, significance shall be judged with respect to earnings (or changes in net assets) and total assets or total liabilities, or, when changes in fair value are recognized in other comprehensive income, with respect to total equity. [Emphasis added]

The boards decided to require sensitivity disclosure in response to comments received from IFRS financial statement users and from comments received in response to the exposure draft that led to ASU 2010-06.⁶ IFRS users indicated to the boards that the “measurement uncertainty analysis disclosure required by IFRS 7⁷” provides useful information that helps them assess the subjectivity of a reporting entity’s fair value measurements categorized within Level 3 of the fair value hierarchy.” However, users also thought the IFRS 7 requirements could be enhanced to include the effect of correlation between unobservable inputs because such information would help them “to assess the extent to which using a different unobservable input can affect a fair value measurement.” The boards agreed that an uncertainty analysis would be more meaningful if, when relevant, the correlation between unobservable inputs is taken into account.

Editor’s Note: For entities that do not currently provide the sensitivity analysis or have it readily available, preparing the proposed disclosures may prove challenging. Entities may need to consider (1) upgrading their information technology systems and existing valuation models to comply with the proposed disclosure requirements and (2) the effect of those disclosure requirements on their internal controls over financial reporting. For financial instruments that an entity may be required to measure at fair value as a result of the proposed amendments to other Codification topics, the entity would need to assess whether its internal personnel are sufficiently well versed in fair value measurements to comply with the additional fair value requirements.

In addition, the proposal:

- Requires disclosure when the highest and best use of an asset differs from its current use. In this instance, a reporting entity discloses the reason its use of the asset is different from the highest and best use.
- Requires disclosure of fair value by level for each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed.

⁶ FASB Accounting Standards Update No. 2010-06, *Improving Disclosures About Fair Value Measurements*.

⁷ IFRS 7, *Financial Instruments: Disclosures*.

The boards decided to require sensitivity disclosure in response to comments received from IFRS financial statement users and from comments received in response to the exposure draft that led to ASU 2010-06.

- Amends the Level 3 reconciliation requirements. ASU 2010-6 recently amended ASC 820 to require disclosure of **significant transfers** between Level 1 and Level 2 of the fair value hierarchy. The proposed ASU amends the disclosure requirement to include **any transfers** between Level 1 and Level 2 of the fair value hierarchy.

Convergence With IFRSs

The FASB and the IASB worked together with the objective of creating a common standard under U.S. GAAP and IFRSs. In May 2009, the IASB issued an ED that proposed replacing all of the existing guidance on fair value measurement under IFRSs with a single standard that was broadly similar to ASC 820 under U.S. GAAP. Then, in October 2009, the boards agreed to develop converged fair value guidance. On the basis of the boards' decisions, the fair value measurement and disclosure requirements to be issued under IFRSs are expected to be nearly identical to those in the proposed ASU, with the following exceptions:

- Certain style differences (e.g. differences in spelling and differences in references to other U.S. GAAP and IFRSs).
- The assets, liabilities, and equity instruments measured at fair value under IFRSs may differ from those measured at fair value under U.S. GAAP as a result of the different measurement bases prescribed by other literature under IFRSs or U.S. GAAP (e.g., currently the measurement bases for financial instruments are different under IFRSs and U.S. GAAP).
- Differences in the recognition of day-one gains or losses that arise when the initial fair value of an asset or liability differs from the transaction price. For example, under IAS 39, gains and losses related to unobservable market data are precluded from immediate recognition. Under U.S. GAAP, there is no similar requirement.
- Differences related to the U.S. GAAP guidance on net asset value per share.⁸ This guidance provides a practical expedient that, under circumstances, permits an entity to measure the fair value of investments in certain entities that apply investment-company accounting on the basis of net asset value per share. The IASB is not including this guidance in IFRSs because there are no equivalent investment-company accounting requirements under IFRSs.
- Differences in disclosure requirements. For example, IFRSs do not require a reporting entity to distinguish between recurring and nonrecurring fair value measurements. In addition, amounts disclosed in Level 3 of the fair value hierarchy may differ because under IFRSs, net presentation for derivatives generally is not permitted.

The fair value measurement and disclosure requirements to be issued under IFRSs are expected to be nearly identical to those in the proposed ASU.

Effective Date and Transition

The proposed ASU does not yet specify an effective date. The FASB plans to add one after considering the comments it receives on the proposal.

If a change occurs in the fair value measurement of an item as a result of applying the amendments in the proposed ASU, the transition would be applied via a cumulative-effect adjustment in beginning retained earnings in the period of adoption. The additional proposed disclosures would be required prospectively. That is, a reporting entity would provide those disclosures for periods beginning after the amendments in the proposed ASU are effective.

Next Steps

After the proposed ASU's comment period closes, the boards will jointly redeliberate the comments received. The FASB's goal is to issue a final ASU during the first quarter of 2011.

⁸ FASB Accounting Standards Update No. 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*.

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