

Power & Utilities Spotlight

ASU 2011-04: Full Disclosures — A Look at What Companies Are Doing

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The Bottom Line

Deloitte examined the second-quarter interim financial statements of 25 calendar-year-end companies in the power and utilities industry to identify trends and differences in the way these companies implemented the revised requirements.

- In May 2011, the FASB issued ASU 2011-04,¹ which amended the measurement principles in ASC 820² and expanded the disclosure requirements for Level 3 fair value measurements.
- The ASU's guidance became effective for interim and annual periods beginning after December 15, 2011.
- Deloitte examined the second-quarter interim financial statements of 25 calendar-year-end companies in the power and utilities industry to identify trends and differences in the way these companies implemented the revised requirements.
- Adoption of the ASU appears to have had a minimal impact on the valuation of derivatives classified as Level 3; however, the majority of companies in our sample expanded their fair value measurement disclosures.
- We observed diversity in companies' application of the new disclosure requirements.
- Our analysis focused on the (1) nature and type of information disclosed, (2) disaggregation or "amount" of information disclosed, (3) use of third-party pricing information, (4) narrative description of sensitivity to changes in unobservable inputs, and (5) valuation processes for Level 3 fair value measurements.
- We expect that power and utility companies will continue to refine their disclosures as they gain more experience with the ASU and review the disclosures of other companies.

¹ FASB Accounting Standards Update No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.

² For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the FASB Accounting Standards Codification."

Beyond the Bottom Line

This *Power & Utilities Spotlight* examines how entities in the power and utilities industry have implemented the disclosure requirements of ASU 2011-04. In the power and utilities industry, the predominant Level 3 financial instruments are commodity derivatives. The ASU gives several examples illustrating how companies should comply with the disclosure requirements, but the examples are related to common instruments in the financial services industry and are difficult to apply to commodity derivative instruments. Companies in the power and utilities industry have therefore found it challenging to determine how to comply with the ASU.

This publication examines the second-quarter interim financial statements of 25 calendar-year-end companies in the power and utilities industry to identify trends and differences in the way these companies implemented the revised requirements.

Background

In May 2011, the FASB issued ASU 2011-04, which resulted in several amendments to ASC 820, including several changes to measurement principles (e.g., consideration of offsetting credit and market risks) and expanded disclosure requirements for Level 3 fair value measurements. (For more information about the ASU's amendments, see Deloitte's May 13, 2011, [Heads Up](#).) For public companies, the guidance in the ASU is effective for interim and annual periods beginning after December 15, 2011.

Although the adoption of ASU 2011-04 appears to have had a minimal impact on the valuation of derivatives classified as Level 3, the majority of companies in our sample expanded their fair value measurement disclosures to comply with the ASU's Level 3 disclosure requirements. Accordingly, our analysis focused on implementation of the expanded Level 3 disclosure requirements, which we have divided into the following subtopics:

- Nature and type of information disclosed.
- Disaggregation or "amount" of information disclosed.
- Use of third-party pricing information.
- Narrative description of sensitivity to changes in unobservable inputs.
- Valuation processes for Level 3 fair value measurements.

Disclosure Observations

ASC 820-10-50-2(bbb) (as amended by ASU 2011-04) requires reporting entities to disclose quantitative information about the significant unobservable inputs used in arriving at Level 3 fair value measurements. Before the issuance of ASU 2011-04, reporting entities were required to disclose only qualitative information about valuation technique(s) and inputs used.

For each company in the sample, we first assessed whether the company appeared to have adopted the ASU. Of the 25 company filings reviewed, eight did not include a table or otherwise disclose quantitative information about unobservable inputs as prescribed by the ASU. Of these eight companies, four disclosed that they had adopted the provision and had included a disclosure such as "X Company implemented the accounting and disclosure guidance effective Jan. 1, 2012, and the implementation did not have a material impact on its consolidated financial statements." Another company described its model for estimating financial transmission rights (FTRs), noting that because FTR settlements are included in a fuel clause adjustment, fair value does not affect income. This company's disclosure further stated, "Given this regulatory treatment and the limited magnitude of FTRs relative to its electric utility operations, the numerous unobservable quantitative inputs to the complex model used for valuation of FTRs are insignificant to the consolidated financial statements of [X Company]." The remaining four companies that did not include quantitative information in accordance with the ASU all had some

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Level 3 financial instruments and did not disclose the impacts on the financial statements. The paragraphs below assess the disclosures of the remaining 17 companies (sample population).

Nature and Type of Information Disclosed

Disclosure Requirements

The ASU does not specify the type of quantitative information to disclose, but the ASU's sample disclosures suggest that for each class of asset or liability, a reporting entity might disclose a range of values and a weighted average for each significant unobservable input.

Assessment of Sample Population

Of the 17 companies in our sample population, 70 percent disclosed a range for the value of identified unobservable inputs while the remaining 30 percent included both a range and weighted average. In some instances, companies that presented only a range in their Level 3 quantitative input disclosures also provided supplementary information, such as periods covered for the derivative contracts.

Observations

Companies that choose to disclose only a range of input values might want to consider providing additional information to supplement those values. For example, in measuring the fair value of forward contracts for electricity, one company in our sample population disclosed a range of \$8 to \$218 per megawatt hour for the electric forward price inputs while another disclosed an electric forward price input range of \$20 to \$67 per megawatt hour. In this case, without additional details, users may be less able to evaluate the relevance of the two companies' differing electric forward price input ranges.

Information that may help financial statement users understand and evaluate the inputs used include any outliers for the range of values (such as peak periods at a highly congested location), a weighted-average value of inputs used, or any other information that might supplement the quantitative disclosure (such as the range of the forward period). For example, one company in our sample population indicated that its range for the electric forward prices input was \$23 to \$73 per megawatt hour but also disclosed that the weighted average was \$42 per megawatt hour.

Disaggregation or "Amount" of Information Disclosed

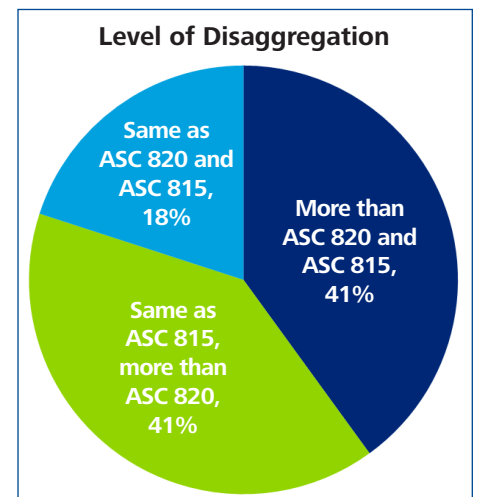
Disclosure Requirements

ASC 820-10-50-2B requires that a reporting entity use judgment in determining the level of disaggregation for its disclosures about unobservable inputs.

Assessment of Sample Population

To better understand the disaggregation techniques used by the 17 companies in our sample population, we first compared the companies' disaggregation for their disclosures about assets and liabilities under ASU 2011-04 with their disaggregation for disclosures under ASC 820 and ASC 815. Both ASC 820 and ASC 815 require disaggregation by contract type (e.g., commodity, foreign exchange, interest rate); however, ASC 815 also requires other types of disaggregation, namely by underlying risk exposure.

The chart to the right summarizes, for the companies in our sample population, disaggregation levels for disclosures about Level 3 assets and liabilities under ASU 2011-04 compared with those for disclosures under ASC 820 and ASC 815.



Companies that choose to disclose only a range of input values might want to consider providing additional information to supplement those values.

Most of the 17 companies in our sample population disclosed significant inputs for financial instruments in a manner consistent with, or in more detail than, their disaggregation of assets and liabilities under ASC 815. Only two companies did not disaggregate beyond the commodity level; the remaining 15 disaggregated into various categories of commodity instruments. Some differences in companies' level of disaggregation under ASU 2011-04 appear to be due to the variety of the categories into which companies had disaggregated to comply with the disclosure requirements of ASC 815. The two tables below illustrate the variety of disaggregation for ASU 2011-04 disclosures:

Commodity by Instrument						
Commodity Contracts	June 30, 2012 Fair Value (Millions)		Valuation Technique	Significant Unobservable Input	Range	
	Assets	Liabilities				
Electricity						
Forward contracts ^a	\$ 67	\$ 88	Discounted cash flows	Electricity forward price (per MWh) ^b	\$20.67–\$67.18	
Option contracts	–	25	Option model	Electricity forward price (per MWh)	\$29.13–\$99.27	
				Natural gas forward price (per MMBtu) ^c	\$2.69–\$4.11	
				Implied electricity price volatilities	15%–151%	
				Implied natural gas price volatilities	18%–56%	
Natural gas						
Forward contracts	2	1	Discounted cash flows	Natural gas forward price (per MMBtu)	\$2.60–\$4.18	
Total	<u>\$ 69</u>	<u>\$ 144</u>				
^a Includes swaps and physical and financial contracts.						
^b MWh stands for megawatt hour, one million watts per hour.						
^c MMBtu stands for one million British thermal units.						

Commodity by Product					
	Fair Value				
	Assets and Liabilities		Valuation Technique(s)	Unobservable Input	Range [Weighted Average]
Level 3 derivative assets and liabilities — commodity contracts ^a					
Fuel oils	\$ 6	\$ (2)	Discounted cash flows	Escalation rate (%) ^c	0.50–0.78 [0.72]
				Counterparty credit risk (%) ^{d,e}	0.12–4 [2]
				[Issuer's] credit risk (%) ^{d,e}	4–23 [9]
			Option model	Volatilities (%) ^c	23–33 [26]
Power ^b	182	(192)	Option model	Volatilities (%) ^d	17–143 [34]
				Average bid-ask consensus peak and off-peak pricing — forwards/swaps (\$/MWh) ^d	21–44 [36]
			Discounted cash flows	Average bid-ask consensus peak and off-peak pricing — forwards/swaps (\$/MWh) ^d	18–51 [34]
				Estimated auction price for financial transmission rights (\$/MWh) ^c	(672)–7,200 [138]
				Nodal basis (\$/MWh) ^c	(6)–(0.50) [3]
				Counterparty credit risk (%) ^{d,e}	0.06–12 [4]
				[Issuer's] credit risk (%) ^{d,e}	4–5 [5]
			Fundamental energy production model	Estimated future gas prices (\$/MMBtu) ^c	4–6 [5]
			Contract price allocation	Estimated renewable energy credit costs (\$/credit) ^c	5–7 [6]
Uranium	–	(1)			62–63 [62]
			Option model	Volatilities (%) ^c	23–33 [24]
^a The derivative asset and liability balances are presented net of counterparty credit considerations.					
^b Power valuations use visible third-party pricing evaluated by month for peak and off-peak through 2015. Valuations beyond 2015 use fundamentally modeled pricing by month for peak and off-peak.					
^c Generally, significant increases (decreases) in this input in isolation would result in a significantly higher (lower) fair value measurement.					
^d Generally, significant increases (decreases) in this input in isolation would result in a significantly lower (higher) fair value measurement.					
^e Counterparty credit risk is only applied to derivative asset balances. [X Company's] credit risk is only applied to derivative liability balances.					

Companies may be implementing the disclosure requirements differently because the ASU's guidance is unclear and because the significance of Level 3 unobservable inputs to the financial statements varies from company to company.

Further assessment of the individual unobservable inputs disclosed showed that most companies appear to have disclosed only the most significant Level 3 inputs. We did not identify any instances in which companies disclosed Level 1 or Level 2 inputs that affected the Level 3 measurement of the related asset or liability.

Observation

Companies may be implementing the disclosure requirements differently because the ASU's guidance is unclear and because the significance of Level 3 unobservable inputs to the financial statements varies from company to company.

Use of Third-Party Pricing Information

Companies in the power and utilities industry often use third-party pricing information when calculating fair value measurements. For example, entities often use broker quotes for commodity (e.g., electricity and natural gas) contracts transacted in over-the-counter markets. In addition, entities with nuclear decommissioning trusts often use price quotes from pricing vendors when valuing trust assets, such as fixed-income securities. Instruments for which third-party pricing information is considered in the calculation of fair value measurements are typically classified as either Level 2 or Level 3 in the fair value hierarchy.

Third-Party Pricing Exception

Disclosure Requirements

ASC 820-10-50-2(bbb) (as amended by ASU 2011-04) requires companies to disclose quantitative information about the significant unobservable inputs used in their Level 3 fair value measurements; however, companies are not required to disclose such inputs if they have not been developed by the reporting entity ("third-party pricing exception").

Assessment of Sample Population

None of the 17 companies in our sample population indicated that they had used the third-party pricing exception in their fair value measurement disclosures.

Observation

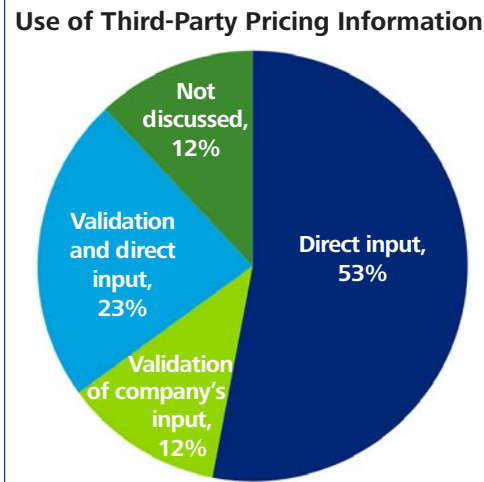
Given the SEC's view³ that management must own the estimates (including fair value measurements) in its financial statements, election of the third-party pricing exception may be rare.

Disclosed Use of Third-Party Pricing Information in the Calculation of Fair Value

Although this topic is not directly related to the adoption of ASU 2011-04, we reviewed the disclosures to assess whether information disclosed about the use of third-party pricing inputs for any fair value measurements (primarily Level 2 or 3 measurements) could be viewed as being in conflict with the SEC's view that management must own estimates reported in its financial statements.

Assessment of Sample Population

Of the 17 companies in our sample population, 95 percent disclosed that they used third-party pricing sources in measuring fair value (for both commodity transactions and trust assets). The chart to the right illustrates companies' use of such pricing sources.



³ As indicated in speeches at the 2011 AICPA National Conference on Current SEC and PCAOB Developments.

Management should be making reasonable efforts to gather qualitative and quantitative information about valuation inputs developed by third parties to determine that this information is developed in accordance with the calculation principles in ASC 820.

As indicated in the chart, these companies disclosed that third-party pricing information was used as (1) a direct input into the fair value measurement valuation (53 percent of the companies sampled), (2) a data point to validate management's internally developed pricing input information (12 percent), or (3) a combination of both⁴ (23 percent). The remaining 12 percent of companies provided no additional discussion of how the third-party pricing information was used.

Observation

Regarding the use of third-party pricing information as a direct input in the calculation of fair value, ASC 820-10-35-54K notes that the use of quoted prices from third parties is appropriate as long as those prices are developed in accordance with ASC 820. From their disclosures, it was often unclear how companies in our sample population that use these third-party prices as direct inputs in their valuation models ensured that these inputs are developed in accordance with ASC 820.

In speeches at the 2011 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff noted that management is responsible for ensuring that fair value measurements based on third-party information are consistent with U.S. GAAP as well as for maintaining effective internal controls over financial reporting that prevent or detect material misstatements in these measurements. Management should be making reasonable efforts to gather qualitative and quantitative information about valuation inputs developed by third parties to determine that this information is developed in accordance with the calculation principles in ASC 820. Examples of such information include (but are not limited to) the third party's calculation models, the types and sources of inputs used in the third party's calculation models, and a comparison of these models with other available third-party pricing sources. Management should also gather sufficient information to comply with ASC 820's overall disclosure requirements, such as the appropriate classification of the associated fair value measurement within the fair value hierarchy and the description of the valuation techniques and inputs used to develop the fair value. In addition, management should consider describing how it determined that the information was developed in accordance with ASC 820, especially when such measurements are considered significant or material to the financial statements.⁵

For more information about the responsibility of management over third-party pricing services, see Deloitte's December 14, 2011, *Heads Up*.

Narrative Description of Sensitivity to Changes in Unobservable Inputs

Disclosure Requirements — Sensitivity

ASC 820-10-50-2(g) (added by ASU 2011-04) requires that reporting entities provide "a narrative description of the sensitivity of [recurring Level 3 fair value measurements] to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement."

Assessment of Sample Population

Approximately 75 percent of the 17 companies analyzed inserted a sentence or two describing how a change to each significant unobservable input would affect the relevant fair value measurement. This disclosure was generally inserted either after the disclosure of quantitative information for each significant unobservable input or as part of the disclosure of valuation techniques. In several instances, the disclosure of this information was included as a footnote to the tabular disclosure of quantitative information about unobservable inputs. The following three examples illustrate how sensitivities were disclosed:

⁴ For example, multiple inputs used to develop a market average price, which are simultaneously used in the cross-validation of the multiple third-party pricing inputs.

⁵ See ASC 820-10-50-2(f) and ASC 820-10-55-104.

Example 1 — Footnote to Quantitative Information

	Quantitative Information About Level 3 Fair Value Measurements			
	Fair Value, Net Asset (Liability)	Valuation Technique	Unobservable Input(s)	Range (Weighted Average ^a)
Energy commodities				
Retail natural gas sales contracts	30	Discounted cash flow	Observable wholesale prices used as proxy for retail delivery points	20%–100% (69%)
Power sales contracts	(7)	Discounted cash flow	Basis price between delivery points	24%–61% (25%)
Full-requirement sales contracts	11	Discounted cash flow	Customer migration	13%–80% (34%)
Auction rate securities	15	Discounted cash flow	Modeled from SIFMA ^b Index	54%–80% (65%)
Cross-currency swaps	10	Discounted cash flow	Credit valuation adjustment	25%–37% (32%)
^a For energy commodities and auction rate securities, the range and weighted average represent the percentage of fair value derived from the unobservable inputs. For cross-currency swaps, the range and weighted average represent the percentage decrease in fair value due to the unobservable inputs used in the model to calculate the credit valuation adjustment.				
^b Securities Industry and Financial Markets Association.				

Example 2 — Tabular Disclosure

Sensitivity of the fair value measurements to changes in the significant unobservable inputs is as follows:

Significant Unobservable Inputs	Position	Change to Input	Impact on Fair Value Measurement
Market price	Buy	Increase (decrease)	Gain (loss)
Market price	Sell	Increase (decrease)	Loss (gain)
Price volatility	Buy	Increase (decrease)	Gain (loss)
Price volatility	Sell	Increase (decrease)	Loss (gain)
Price correlation	Buy	Increase (decrease)	Loss (gain)
Price correlation	Sell	Increase (decrease)	Gain (loss)
Load factor	Sell ^a	Increase (decrease)	Loss (gain)
Usage factor	Sell ^b	Increase (decrease)	Gain (loss)
^a Assumes the contract is in a gain position and load increases during peak hours.			
^b Assumes the contract is in a gain position.			

Example 3 — Narrative Disclosure

Significant increases or decreases in future power or capacity prices in isolation would decrease or increase, respectively, the fair value of the derivative liability. Any increases in the risk premiums would increase the fair value of the derivative liabilities.

Disclosure Requirements — Interrelationships

To the extent that there are interrelationships between significant unobservable inputs and other unobservable inputs used in the fair value measurement, the ASU requires a reporting entity to describe those interrelationships and how they might magnify or mitigate the effect of changes in the unobservable inputs on a fair value measurement. At a minimum, the narrative description must include the unobservable inputs for which quantitative information is disclosed.

Assessment of Sample Population

Only 20 percent of the 17 companies disclosed information about the interrelationships between unobservable inputs, and such disclosures were generally high-level. The following are two examples of disclosures about interrelationships between unobservable inputs:

On the basis of our review of the disclosures provided by the 17 companies in our sample population, we believe that some companies may want to consider refining or providing additional information in their disclosures in subsequent periods.

Example 1

The inputs listed above would have a direct impact on the fair values of the above instruments if they were adjusted. The significant unobservable inputs used in the fair value measurement of [X Segment's] commodity derivatives are forward commodity prices and for options is price volatility. Increases (decreases) in the forward commodity price in isolation would result in significantly higher (lower) fair values for long positions (contracts that give us the obligation or option to purchase a commodity), with offsetting impacts on short positions (contracts that give us the obligation or right to sell a commodity). Increases (decreases) in volatility would increase (decrease) the value for the holder of the option (writer of the option). Generally, a change in the estimate of forward commodity prices is unrelated to a change in the estimate of volatility of prices. An increase in the reserves listed above would decrease the fair value of the positions. An increase in the heat rate or renewable factors would increase the fair value accordingly. Generally, there are interrelationships between market prices of natural gas and power. Therefore, an increase in natural gas pricing could have a similar impact on forward power markets.

Example 2

Our option contracts classified as Level 3 are primarily related to purchase heat rate options. The significant unobservable inputs for these instruments include electricity prices, gas prices, and implied volatilities. If electricity prices and electricity price implied volatilities increase we would expect the fair value of these options to increase, and if these valuation inputs decrease we would expect the fair value of these options to decrease. If natural gas prices and natural gas price implied volatilities increase we would expect the fair value of these options to decrease, and if these inputs decrease we would expect the fair value of the options to increase. The commodity prices and implied volatilities do not always move in corresponding directions. The options' fair values are affected by the net changes of these various inputs.

Observation

On the basis of our review of the disclosures provided by the 17 companies in our sample population, we believe that some companies may want to consider refining or providing additional information in their disclosures in subsequent periods. We observed that some of the companies in our sample population:

- Did not include all significant unobservable inputs for which quantitative information was disclosed in their description of measurement sensitivity.
- Did not provide explicit information on the interrelationships between unobservable inputs.

In the Basis for Conclusions of ASU 2011-04, the FASB describes why it decided to require a narrative description of measurement uncertainty and the interrelationships between significant unobservable inputs. On the basis of paragraphs BC93–BC98, we note the following:

- The FASB originally proposed that entities disclose a quantitative sensitivity analysis but rejected this proposal in response to preparer feedback even though users (including investors) supported it. The IASB retained the requirement in its final standard, IFRS 13.⁶
- Paragraph BC96 states that “[t]he Boards concluded that [the required] information would provide users . . . with information about how the selection of unobservable inputs affects the valuation of a particular class of assets or liabilities.” In addition, paragraph BC97 indicates that the information “provides users . . . with information about the directional effect of a change in a significant unobservable input on a fair value measurement,” enabling them to “assess whether the reporting entity’s views about individual inputs differed from their own.”

⁶ IFRS 13, *Fair Value Measurement*.

- Paragraph BC96 also states that “[t]he Boards expect that the narrative description will focus on the unobservable inputs for which quantitative information is disclosed because those are the unobservable inputs that the entity has determined are most significant to the fair value measurement.”

The FASB also indicated that it would continue to assess whether a quantitative measurement uncertainty analysis should be required.

Valuation Processes for Level 3 Fair Value Measurements

Disclosure Requirements

For both recurring and nonrecurring Level 3 fair value measurements, ASU 2011-04 requires reporting entities to disclose a description of the valuation processes they used. This description may include, for example, how a reporting entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period. (See ASC 820-10-50-2(f) and ASC 820-10-55-105.) The Board decided to introduce this disclosure requirement because financial statement users believed that such information would be helpful in an assessment of the relative subjectivity of the reporting entity’s fair value measurements, particularly for those categorized in Level 3 of the fair value hierarchy. (See paragraph BC91 of ASU 2011-04.)

Assessment of Sample Population

We observed a wide range in the level of detail for disclosures about the valuation processes for Level 3 fair value measurements. The level of detail ranged from a short paragraph covering all Level 3 measurements to several paragraphs covering valuation processes for each class of asset or liability separately. ASC 820-10-55-105 suggests items to include in a disclosure of the valuation processes for Level 3 measurements. Only two entities from our sample population provided some level of disclosure about all items suggested in ASC 820-10-55-105. However, we noted that almost all of the 17 companies in our sample population provided some of the suggested information in their disclosure:

- 65 percent disclosed the responsible group and internal reporting procedures.
- 24 percent disclosed the frequency and methods for testing pricing methods, with an additional 30 percent disclosing only the frequency.
- 12 percent disclosed the process for analyzing changes in fair value.
- 59 percent disclosed the methods used to develop and substantiate unobservable inputs.

The following is an example of a disclosure containing several of the items suggested by ASC 820-10-55-105:

Example

[X Company’s] commodity derivative valuations are prepared by the Enterprise Risk Management (ERM) department. The ERM department reports directly to the Companies’ CFO. The ERM department creates a daily computer-generated file containing mark-to-market valuations for the Companies’ derivative transactions. Standard transactions are programmatically calculated using software. The inputs that go into the mark-to-market valuations are transactional information stored in the systems of record and market pricing information that resides in data warehouse databases. The majority of forward prices are automatically uploaded into the data warehouse databases from various third-party sources. Inputs obtained from third-party sources are evaluated for reliability considering the reputation, independence, market presence, and methodology used by the third-party. If forward prices are not available from third-party sources, then the ERM department models the forward prices based on other available market data. A team consisting of risk management and risk quantitative analysts meets each business day to assess the validity of market prices and mark-to-market valuations. During this meeting, the changes in mark-to-market valuations from period to period are examined and qualified against historical expectations. If any discrepancies are identified during this process, the mark-to-market valuations or the market pricing information is evaluated further and adjusted, if necessary.

We observed a wide range in the level of detail for disclosures about the valuation processes for Level 3 fair value measurements.

We expect power and utilities companies will continue to refine their disclosures as they gain more experience with the ASU and benefit from reviewing the disclosures of other companies.

Example (continued)

[The Company] enter(s) into certain physical and financial forwards and futures, options, and full requirements contracts, which are considered Level 3 as they have one or more inputs that are not observable and are significant to the valuation. The discounted cash flow method is used to value Level 3 physical and financial forwards, futures, and full requirements contracts. An option model is used to value Level 3 physical and financial options. The discounted cash flow model for forwards and futures calculates mark-to-market valuations based on forward market prices, original transaction prices, volumes, risk-free rate of return and credit spreads. Full requirements contracts add load shaping and usage factors in addition to the discounted cash flow model inputs. The option model calculates mark-to-market valuations using variations of the Black-Scholes option model. The inputs into the models are the forward market prices, implied price volatilities, risk-free rate of return, the option expiration dates, the option strike prices, price correlations, the original sales prices, and volumes. For Level 3 fair value measurements, the forward market prices, the implied price volatilities, price correlations, load shaping, and usage factors are considered unobservable. The unobservable inputs are developed and substantiated using historical information, available market data, third-party data, and statistical analysis. Periodically, inputs to valuation models are reviewed and revised as needed, based on historical information, updated market data, market liquidity and relationships, and changes in third-party pricing sources.

Observation

Companies often provided information about their valuation processes to meet the disclosure requirement but may want to consider whether their disclosures sufficiently describe their valuation processes for their Level 3 measurements, as intended by the ASU.

Thinking Ahead

The adoption of ASU 2011-04 has led to a noticeable increase in the amount and type of information that companies have disclosed about fair value measurements. We expect power and utilities companies will continue to refine their disclosures as they gain more experience with the ASU and benefit from reviewing the disclosures of other companies. How regulators interpret the requirements will most likely play a significant role in any future refinements.

Editor's Note: On July 12, 2012, the FASB issued a discussion paper (DP) to obtain feedback from stakeholders on its project to develop a framework to make financial statement disclosures "more effective, coordinated, and less redundant." The DP, which is not a FASB proposal or preliminary views, identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. If implemented, some of the ideas in the DP could significantly change the Board's process for creating disclosure requirements in future standards and could potentially alter those in existing standards. ASU 2011-04 requires a significant amount of disclosures for companies with Level 3 financial instruments. When changes in the unobservable inputs do not materially affect a company's financial statements, the company may be uncertain about the level of disclosures to provide. The disclosure framework project may result in fewer disclosures in such circumstances.

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