

MINUTES



To: Board Members
From: Hurst (ext. 262)
Subject: Minutes of the August 27, 2003 FVM Board Meeting **Date:** August 27, 2003
cc: Bielstein, Smith, Petrone, FVM Team, Bossio, Tovey, Monroe, Swift, Polley, Gabriele, Thompson, Mahoney, Leisenring (IASB), Sutay, FASB Intranet

Topic: CON 7 Guidance

Basis for Discussion: Memorandums dated July 31, 2003, and August 7, 2003, and Audience Handout (attached)

Length of Discussion: 1:30 p.m. to 2:00 p.m.

Attendance:

Board members present: Batavick, Crooch, Herz, Schieneman, Schipper, Seidman, Trott

Board members absent: None

Staff in charge of topic: Pinson

Other staff at Board table: Bielstein, Hurst, MacDonald, McKenna

Outside participants: None

Summary for ACTION ALERT

The Board discussed the guidance for using present value to estimate fair value in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. The Board decided to revise one aspect of that guidance and to clarify the terminology used to describe various methods that will be carried forward to the fair value standard.

The Board decided to refer to the *expected cash flow approach* in Concepts Statement 7 as an *expected present value technique*. The Board clarified that an expected present value technique is consistent with the use of probability-weighted (expected) cash flows that either are (a) explicitly adjusted for systematic risk and discounted at a risk-free rate or (b) discounted using a rate that incorporates a risk premium for the systematic risk inherent in the expected cash flows. In reaching that decision, the Board emphasized the need to adjust for systematic risk (in either the expected cash flows or the discount rate), and decided to eliminate the potential default of no risk adjustment in certain circumstances in paragraphs 62 and 68 of Concepts Statement 7.

The Board also decided to refer to the *traditional approach* in Concepts Statement 7 as a *discount rate adjusted approach* (present value technique). The Board clarified that a discount rate adjustment present value technique is consistent with the use of contractual cash flows, a most-likely estimate of cash flows, or a best-estimate of cash flows, each discounted at a discount rate commensurate with the risks inherent in the cash flows.

Matters Discussed and Decisions Reached

Mr. Pinson asked Board members to consider the existing guidance in Concepts Statement 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, regarding the use of present value techniques to estimate fair value and to discuss the staff's recommendations to modify that guidance as outlined in the audience handout.

1. Expected Cash Flow Approach

The Board agreed with the staff's recommendation to allow the use of both the expected cash flow approach in Concepts Statement 7 as well as the approach more widely used in practice, which involves the discounting of expected cash flows using a discount rate that incorporates a risk premium for the systematic risk inherent in the expected cash flows. The Board clarified that approach as consistent with the use of probability-weighted (expected) cash flows that either are (a) explicitly adjusted for systematic risk and discounted at a risk-free

discount or (b) discounted using a discount rate that incorporates a risk premium for the systematic risk inherent in the expected cash flows.

Mr. Trott raised concerns that the lack of clear definitions of the terms *systematic risk* and *non-systematic risk* could result in the double counting for uncertainty. He also expressed concern that many measurers might use a “hurdle” rate, and that such a rate may include a premium for more than systematic risk of the item being measured. Use of a hurdle rate calculated using the Capital Asset Pricing Model (CAPM) framework may not be appropriate.

Ms. Schipper noted in some cases, entities use a CAPM framework to calculate their hurdle rates. In these cases, using such a rate to value equity and equity-like things might be consistent with the staff’s proposal. The staff agreed to address these matters and to provide sufficient education about the differences between systematic and non-systematic risks in its modifications to Concepts Statement 7.

2. Risk Adjustment Default

A majority of the Board agreed to eliminate the language in paragraphs 62 and 68 of Concepts Statement 7 that provides a potential “default” allowing the use of present value without consideration of a risk premium, such as when the measurer may consider it too difficult to reliably assess. Mr. Pinson pointed out that while in some cases, the use of such a default might result in a reasonable estimate of fair value when the risk premium is small, there also is potential for material misstatement where the risk premium is significant if it is not taken into consideration. Ms. Seidman stated that “Level 3” of the fair value hierarchy should address situations where it is difficult to estimate fair value. Mr. Herz suggested the staff consider disclosure requirements relating to such estimates, particularly as the selected estimate may come from a broad range of possible values. Ms. MacDonald acknowledged that disclosure requirements may be addressed at some point in the Fair Value project, though that is yet to be determined.

3. Terminology

Mr. Pinson indicated that some of the terminology in Concepts Statement 7 is misunderstood by valuation professionals and accounting practitioners.

Board members agreed to refer to the *expected cash flow approach* in Concepts Statement 7 as an *expected present value technique*, consistent with the use of the term in existing and recent standards.

The Board also agreed with the staff recommendation to refer to the *traditional approach* in Concepts Statement 7 as a *discount rate adjusted approach* (present value technique), further clarifying that present value technique is consistent with the use of contractual cash flows, a most-likely estimate of cash flows, or a best estimate of cash flows, each discounted at a discount rate commensurate with the risks inherent in the cash flows. The staff and Board believe this change will alleviate some of the existing confusion resulting from the varying terminology.

Ms. MacDonald reminded the Board that the discussion at this Board meeting concluded its deliberations on Concepts Statement 7, clarifying that the staff's intent is to clarify, not reconsider, the substantive guidance in Concepts Statement 7 that will be carried forward to the fair value standard.

Follow-up Items:

None.

General Announcements:

None.

**Board Handout
Fair Value Measurement**

At its August 27, 2003 meeting, the Board will discuss the guidance for using present value techniques to estimate fair value in CON 7, specifically, whether to modify that guidance to:

- 1. Clarify application of the expected cash flow approach*
- 2. Eliminate the potential default to no risk adjustment when using an expected cash flow approach, if the related risk assessment is difficult or deemed unreliable*
- 3. Clarify related terminology.*

Each item will be discussed separately.

1. Clarify application of the expected cash flow approach

Do Board members agree with the staff recommendation that the Board modify the guidance in CON 7 for the expected cash flow approach to allow the use of a discount rate that incorporates a risk premium for systematic risk to discount expected cash flows in addition to a direct risk adjustment to the expected cash flows in conjunction with a risk-free discount rate already specified?

Paragraph 40 of CON 7 refers to the *expected cash flow approach* as a present value technique for estimating market prices in which probability weighted cash flows (expected cash flows) are first adjusted for risk and then are discounted at a risk-free rate. The *expected cash flow approach* as defined is not widely used in practice. The present value technique most often used for estimating market prices is one of discounting expected cash flows using a discount rate that incorporates a risk premium for the systematic risk inherent in the expected cash flows.

2. Eliminate the potential risk-free discount rate default

Do Board members agree with the staff's recommendation that any "default" that potentially allows the use of present value without consideration of risk, such as when the measurer may consider it too difficult to assess, be excluded from any guidance on the use of traditional and expected cash flow approaches to measure fair value?

Paragraphs 62 and 68 of CON 7 can be read to permit a default for discounting risky cash flows using a risk-free discount rate if a risk premium cannot be reliably determined. Paragraph 62 also notes that "an arbitrary adjustment for risk, or one that cannot be evaluated by comparison to marketplace information, introduces an unjustified bias into the measurement." However, the failure to consider any risk premium when it may be significant could lead to an equally biased measure and one that is not consistent with fair value. While there may be some difficulty estimating a risk premium in certain instances, such estimates

are likely not any more difficult to make or prone to any more error or bias than any other variable that is considered in a fair value measurement using present value.

3. Clarify related terminology

a) Do Board members agree with the staff recommendation that the name of the expected cash flow approach referred to in CON 7 be changed to the expected present value approach, consistent with the use of that term in existing standards?

CON 7 refers to the *expected cash flow approach* as a present value technique for estimating market prices in which probability weighted cash flows (expected cash flows) are first adjusted for risk and then are discounted at a risk-free rate. Recent standards, including FAS 142, 143, 144, and 146 refer to the same approach as the *expected present value approach*.

b) Do Board members agree with the staff recommendation that the traditional approach referred to in CON 7 be renamed the discount rate adjustment approach?

Paragraph 43 of CON 7 broadly refers to a *traditional approach* as one that "...used a single set of estimated cash flows and a single interest rate, often described as 'the rate commensurate with the risk.'" The use of the term *traditional approach* in CON 7 creates confusion because the term has a broader meaning among many groups.

In Appendix A of the revised IAS 39 Exposure Draft, the IASB refers to the "discount rate adjustment approach" as one in which "...the stream of contracted cash flows forms the basis for the present value computation, and the rate(s) used to discount those cash flows reflects the uncertainties of the cash flows," similar to the traditional approach described in CON 7. The IASB term is descriptive of the major process of the approach and avoids the confusing term "traditional" in the FASB guidance.