

## MINUTES



**To:** Board Members  
**From:** FVM Team (Murphy, ext. 208)  
**Subject:** Minutes of the September 14, 2005 FVM Board Meeting **Date:** September 20, 2005  
**cc:** Bielstein, L. Smith, Petrone, Fair Value Team, Revenue Recognition Team, Business Combinations Team, Polley, Gabriele, Carney (e-mail), Mahoney, Sutay, Leisenring (IASB), P. Martin (CICA), FASB Intranet

*The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.*

**Topic:** Proposed FASB Statement, *Fair Value Measurements*: restricted securities, disclosures, effective date, transition, and timing

**Basis for Discussion:** Two memoranda dated August 31, 2005, and audience handout (attached)

**Length of Discussion:** 9:30 a.m. to 10:20 a.m.

**Attendance:**

Board members present: **FASB:** Batavick, Crooch, Herz, Schipper, Seidman, Trott, and Young

**IASB:** Leisenring

Board members absent: None

Staff in charge of topic: MacDonald

Other staff at Board table: Belcher, Bielstein, Murphy, L. Smith, Thuener, and Todorova

Outside participants: None

**Summary of Decisions Reached**

The Board clarified aspects of the guidance to be included in a final FASB Statement, *Fair Value Measurements* (FVM Statement). Specifically:

1. The Board clarified that a restricted security refers to a security with legal or contractual restrictions that limit or prohibit sale for a specified period. The fair value of a restricted security, as defined, should be estimated based on the quoted price for an unrestricted security of the issuer, adjusted as appropriate for the effect of the restriction.
2. The Board decided to amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to remove its definition of restricted stock in footnote 2 of paragraph 3(a). Therefore, the fair value of restricted stock included in the scope of that Statement (stock with restrictions that terminate within one year) should be estimated in accordance with the FVM Statement.
3. The Board clarified that fair value estimates within Level 5 should be separately disclosed. In addition, the requirement to disclose unrealized gains or losses applies only if those gains or losses relate to fair value estimates within Level 5.

The Board discussed effective date, transition, and timing of the FVM Statement.

The Board reached the following decisions:

1. The FVM Statement will be effective for financial statements issued for fiscal years beginning after December 15, 2006, except as follows. The fair value disclosures required by the FVM Statement will be effective for financial statements issued for fiscal years ending after December 15, 2006. Earlier application is encouraged.
2. The provisions of the FVM Statement should be initially applied prospectively, except as follows. For large positions of unrestricted securities with quoted prices in active markets (blocks), the provisions of the FVM Statement should be initially applied retrospectively to all prior periods (a "full" retrospective transition approach). The cumulative effect of the change in accounting principle on periods prior to those presented should be reflected in the carrying amounts of the related assets and liabilities as of the beginning of the first period presented. An offsetting adjustment should be made to the opening balance of retained earnings for that period. The disclosures for a change in accounting principle in FASB Statement No. 154, *Accounting Changes and Error Corrections*, are required.

The Board decided not to re-expose the FASB Exposure Draft, *Fair Value Measurements* (FVM ED). The Board plans to issue the FVM Statement by year-end 2005. Before finalizing the FVM Statement, the Board plans to post a working draft of the standards section of the FVM Statement to the FASB website. The working draft will replace the “summary of decisions reached” section in the fair value measurements project update. The Board believes that a working draft will more effectively communicate the decisions reached and does not plan to formally seek comments on the working draft. However, the Board will consider comments on the working draft otherwise provided by interested parties.

### **Objective of Meeting**

The purpose of the meeting was for the Board to discuss several final issues with respect to the FVM Statement.

### **Matters Discussed and Decisions Reached**

#### **Restricted Securities**

1. Ms. MacDonald said the meeting’s first three issues relate to restricted securities, the first of which relates to the definition of a restricted security. The FVM ED defined a restricted security as a security for which sale is legally restricted by governmental or contractual requirement for a specified period. Recently, she noted, some respondents have questioned whether the definition encompasses restrictions that limit sale (for example, to qualifying investors) or prohibit sale. The staff understands that the Board’s intent was to encompass restrictions that both limit and prohibit sale. To more clearly convey that intent, the staff recommends that the Board revise the definition of a restricted security accordingly. All Board members agreed with that staff recommendation.

2. Ms. MacDonald said the second issue relates to the measurement of restricted securities. She said that the FVM ED emphasized the general principle that for a restricted security, the estimate of fair value should be based on the quoted price for an unrestricted security of the issuer, adjusted as appropriate for the effect of the restriction. In addition, the FVM ED included related

implementation guidance found in ASR No. 113, *Statement Regarding "Restricted Securities."* However, that guidance focuses largely on factors that should not be considered in developing the estimate. Largely for that reason, respondents indicated that it would not be particularly useful. She said that in retrospect, the staff agrees. Therefore, the staff recommends that the Board remove that incremental guidance from the FVM Statement. All Board members agreed with that staff recommendation.

3. Ms. MacDonald said the third issue relates to Statement 115. She explained that the FVM ED proposed to amend Statement 115 to clarify that for restricted stock included in the scope of Statement 115 (that is, stock with restrictions that terminate within one year) the guidance in the FVM Statement would apply. However, the FVM ED did not propose to amend Statement 115 to remove its conflicting definition of restricted stock in footnote 2 to paragraph 3(a) (which is included in the audience handout). To eliminate confusion in practice, the staff recommends that the FVM Statement also amend Statement 115 to remove that definition. All Board members agreed with that staff recommendation.

### **Disclosures**

4. Ms. MacDonald said the next issue relates to disclosures, in particular, the disclosure levels within the fair value hierarchy. She explained that the Board's current decisions would require separate disclosure of fair value estimates within Level 1, Levels 2 and 3, and Levels 4 and 5, and disclosure of unrealized gains or losses that relate to fair value estimates within Levels 4 and 5. She said that the staff believes that fair value estimates within Levels 4 and 5 are fundamentally different. Fair value estimates within Level 4 are based principally on market inputs. Fair value estimates within Level 5 are based principally on entity inputs. Moreover, in the proposed FSP relating to 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," fair value estimates within Level 4 would be deemed sufficiently reliable for purposes of recognizing related unrealized gains or losses in income.

Largely for those reasons, she said that the staff recommends that the Board re-designate the disclosure levels, requiring separate disclosure of fair value estimates within Level 1, Levels 2–4, and Level 5, and limit disclosure of unrealized gains or losses to those gains or losses that relate to fair value estimates that fall within Level 5. All Board members agreed with that staff recommendation.

### **Effective Date**

5. Ms. MacDonald explained that earlier, the staff discussed with the Board its recommendation that the provisions of the FVM Statement be effective for financial statements issued for fiscal years beginning after June 15, 2006, except with respect to the provisions that relate to credit standing and liability remeasurements at fair value. In view of related concerns expressed by respondents and some Board members, the staff previously recommended that those provisions be indefinitely deferred, pending further Board action—including through the fair value option project. Ms. MacDonald explained that earlier in the week, some staff and Board members met with a group of constituents to discuss issues relating to credit standing and liability remeasurements at fair value. Participants indicated that credit standing should be included in liability remeasurements at fair value, but that the FVM Statement should allow adequate time for those entities that are not currently considering the effect of changes in their credit standing on liability remeasurements at fair value to do so. She said that in the staff's view, that discussion suggests that the Board should not defer the provisions of the FVM Statement relating to credit standing and liability remeasurements at fair value. Rather, the Board should extend the effective date of the FVM Statement (for example, for financial statements issued for fiscal years beginning after December 15, 2006), with earlier application encouraged.

6. All Board members agreed that the FVM Statement should be effective for financial statements issued for fiscal years beginning after December 15, 2006, as suggested by the staff. However, Mr. Trott said that the disclosure requirements of the FVM Statement should be effective earlier, for financial statements issued for fiscal years ending after December 15, 2006. In that

regard, he noted that in large part, the disclosures compile and put in one place information that is disclosed currently under other accounting pronouncements. Therefore, earlier application would not involve incremental cost and effort. All Board members agreed with Mr. Trott's recommendation.

7. On a related note, Ms. Seidman emphasized that it is important for the Board to complete its separate effort relating to the consideration of other forms of credit enhancements in determining the fair value of a liability before the FVM Statement becomes effective. Otherwise, the related provisions of the FVM Statement might not be generally understood and consistently applied.

### **Transition**

8. Ms. MacDonald said that except for blocks, the staff recommends that the Board affirm the prospective transition approach proposed in the FVM ED. She said that the related guidance in the FVM Statement focuses on the methods used to estimate fair value (a change in accounting principle). However, the methods are referred to generally (for example, in the context of inputs requiring qualitative assessments). Therefore, the effect of a change in the method used to estimate fair value likely will not be separable from the change in the estimate, requiring prospective application (similar to a change in accounting estimate). All Board members agreed with that staff recommendation.

9. Ms. MacDonald said that for blocks, the FVM Statement would specify the change in the method used by certain entities (broker-dealers and some investment companies) to estimate fair value when quoted prices for the individual trading units in active markets are available. She said that the effect of that change in method will be separable from the change in the estimate, requiring retrospective application (similar to a change in accounting principle). She said that in that regard, the staff recommends initial application of the change in accounting principle in the fiscal year in which the Statement is initially applied (a limited retrospective transition approach). Separately, she said that the staff seeks the Board's view on whether the disclosures in Statement 154 for a change in accounting principle should be required, in particular, the disclosures in paragraphs 17(b)(2) and 18.

10. All Board members agreed that for blocks, the change in accounting principle should be initially applied retrospectively. However, because there is no limitation on the availability of information in prior periods, the Board decided that the change in accounting principle should be initially applied retrospectively to all prior periods (a “full” retrospective transition approach).

11. Msrs. Crooch and Batavick said that they would prefer a limited retrospective transition approach, but would not object to a full retrospective transition approach. Similarly, Ms. Seidman said that she would support a prospective transition approach to simplify transition of the FVM Statement concurrent with the related proposed Issue 02-3 FSP. However, she would not object to a full retrospective transition approach.

12. All Board members agreed that the disclosures in Statement 154 for a change in accounting principle should be required. Ms. Seidman said that she questions the benefit provided by those disclosures for blocks, but that she would not object to requiring those disclosures.

### **Timing**

13. Ms. MacDonald said with respect to timing, the threshold issue is whether to re-expose the FVM ED. At this time, she said that the staff does not believe that formal re-exposure is warranted. The revisions to the FVM ED are based largely on input received from respondents and do not change the substantive guidance included, either explicitly or implicitly, in the FVM ED. At the same time, however, the staff believes that the Board, having more fully developed and “repackaged” that guidance and, further, having relied on that guidance in developing the proposed Issue 02-3 FSP, might benefit from an expanded review of that guidance included in a staff draft of the FVM Statement before finalizing the FVM Statement. Ms. MacDonald said in that regard, the staff plans to solicit input from external reviewers (including some or all roundtable participants) through a fatal flaw review. In addition, the staff recommends that the Board post the staff draft of the FVM Statement (in particular, the standards section and the basis for conclusions) on the FASB website while the proposed Issue 02-3 FSP

is out for exposure. She said that in this case, posting to the FASB website would allow:

- a. The Board to issue the Exposure Draft of the proposed Issue 02-3 FSP in a timely manner
- b. Respondents to that Exposure Draft (and others) to provide input on the staff draft of the FVM Statement, as appropriate
- c. The Board to consider any new issues not previously considered before finalizing the FVM Statement.

Ms. MacDonald also indicated that absent a decision to re-expose, the staff expects to be in a position to preballot a final FVM Statement in the fourth quarter.

14. All Board members agreed not to re-expose the FVM ED. All Board members agreed to post a staff draft of the FVM Statement to the FASB website concurrent with posting of the proposed Issue 02-3 FSP. Board members agreed not to seek formal comments on the staff draft other than through its external reviewers, but indicated that it would consider additional comments on the staff draft provided by other interested parties.

15. Mr. Trott suggested that the staff communicate on the FASB website the time frame for the posting of the staff draft (the proposed Issue 02-3 FSP comment period) and the Board's consideration of any input that is received on the staff draft. Ms. Schipper asked the staff to clarify whether it intends to provide the Board with an analysis of any input received on the staff draft and whether, with respect to Issue 02-3, constituents would be told when submitting their comments to view the staff draft of the FVM Statement as a final FVM Statement. Ms. MacDonald responded that the staff would communicate to the Board any issues raised and that constituents would be informed that they should assume the staff draft of the FVM Statement is a final Statement for purposes of commenting on the proposed Issue 02-3 FSP.

**Follow-up Items:**

16. None.

**General Announcements:**

17. None.



Board Meeting Handout

ATTACHMENT

**FAIR VALUE MEASUREMENT PROJECT**  
**September 14, 2005 Board Meeting**

The Board will discuss issues relating to a final FASB Statement, *Fair Value Measurements* (FVM Statement).

**1. RESTRICTED SECURITIES**

The Board will discuss the following with respect to restricted securities:

- a. Whether to revise the definition of restricted securities in the FVM ED to explicitly encompass securities with restrictions that both limit and prohibit sale
- b. Whether to remove the definition of restricted stock in footnote 2 of paragraph 3(a) of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, which states:

*Restricted stock*, for purposes of this Statement, means equity securities for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except if that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year, such as may be the case under Rule 144 or similar rules of the SEC, is not considered restricted.

- c. Whether to retain the related implementation guidance carried forward from SEC ASR No. 113, *Statement Regarding "Restricted Securities"*

## **2. DISCLOSURES**

The Board will discuss the following with respect to fair value disclosures:

- a. Whether to re-designate the disclosure levels, segregating estimates based on quoted prices in active markets for identical assets or liabilities (Level 1), other market inputs, whether directly observable or otherwise derived (Levels 2-4), and entity inputs (Level 5) and, if so, whether to limit disclosure of unrealized gains or losses to those that relate to estimates within Level 5
- b. Alternatively, whether to require disclosure of Level 4 estimates and related unrealized gains or losses separate from Level 5 estimates and related unrealized gains or losses

## **3. TIMING**

The Board will discuss the timing of a final FVM Statement, considering the following:

- a. Whether to re-expose the FVM ED, with issuance of a final Statement in the 1<sup>st</sup> half of 2006
- b. Alternatively, whether to post the staff draft of the final FVM Statement (the standards section and the basis for conclusions) to the FASB website for a limited period (to coincide with the comment period for the FSP relating to 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,"), with issuance of a final Statement in the 4<sup>th</sup> quarter 2005, subject to external reviewer (and other) comments.

## **4. EFFECTIVE DATE**

The Board will discuss the effective date of a final FVM Statement, in particular:

- a. Whether to require that the FVM Statement be effective for financial statements issued for fiscal years beginning after June 15, 2006 with earlier application encouraged
- b. Whether to indefinitely defer the provisions of the FVM Statement relating to credit standing and liability remeasurements, pending further Board action, with application encouraged but not required during that indefinite deferral.

## 5. TRANSITION

The Board will discuss transition of a final FVM Statement:

- a. *Changes in methods.* The substantive guidance in the FVM Statement focuses broadly on the methods used to estimate fair value. A change in the method of applying an accounting principle is considered a change in accounting principle. However, because the methods are referred to generally and likely would be subjectively determined, the effect of that change in accounting principle would be inseparable from the effect of the change in estimate. That type of change is considered a change in estimate. Therefore, the Board will discuss a prospective transition approach, with certain exceptions (as in the FVM ED).
- b. *Blocks.* In its redeliberations, the Board decided to specify the method that should be used by broker-dealers and certain investment companies to estimate the fair value of a block (PxQ). Because that method is specified and is objectively determinable, the effect of that change in accounting principle will be separable from the effect of the change in estimate. Therefore, the Board will discuss a retrospective transition approach, specifically, whether to require a full retrospective transition approach or a limited retrospective transition approach.