MINUTES

Financial Accounting Standards Board

To: Board Members

From: Hurst (ext. 262)

Subject: Minutes of the November 19, 2003 FVM Board Meeting **Date:** November 24, 2003

cc: Bielstein, Smith, Petrone, FVM Team, T. Johnson, Slayton, Sletton, Lott, Bossio, Swift, Polley, Gabriele, Thompson, Mahoney, Leisenring, J. Paul, P. Martin, FASB Intranet

Topic: Fair Value Measurement Scope and Codification Issues (Phase 1)

Basis for Discussion: Memorandum dated November 5, 2003, and Audience Handout (attached)

Length of Discussion: 9:00 a.m. to 10:15 a.m.

Attendance:

Board members present:	Batavick, Crooch (by phone), Herz, Schieneman, Schipper, Seidman, Trott
Board members absent:	None
Staff in charge of topic:	MacDonald, McKenna
Other staff at Board table:	Bielstein, Hurst, Pinson
Outside participants:	None

Summary for ACTION ALERT

The Board discussed scope and codification issues, reconsidering certain decisions reached in its former project to replace FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, which was removed from the Board's agenda in July 2003.

a. The Board decided to exclude from the Phase 1 scope revenue recognition transactions covered under existing pronouncements that require a vendor-specific objective evidence (VSOE) of fair value measurement.

b. The Board reconsidered its December 2001 decision that for financial instruments traded in active markets where prices are quoted in terms of bid and asked prices, the fair value measurement should be determined using the mid-point of the bid-asked spread. The Board decided that the fair value measurement should be determined using bid prices for long positions (assets) and asked prices for short positions (liabilities).

c. The Board decided that for restricted securities, it would not provide explicit guidance to determine fair value. Rather, the existing SEC guidance in ASR No. 113, *Statement Regarding "Restricted Securities"*, should continue to apply, as supplemented by the proposed guidance discussed by the Board in April 2003, which refers to factors that should be included among those considered in developing the measurements including the fair value and volatility of an unrestricted unit of the same security, the nature and duration of the restriction, and the risk-free interest rate.

d. For financial instruments traded in active markets, the Board affirmed its March 2003 decision to retain the principle in Statement 107, which establishes that the unit of account is the individual trading unit and prohibits a fair value measurement using a block discount. That decision would require conforming changes to the AICPA industry guides for broker dealers and investment companies. For assets and liabilities that are not traded in active markets, the Board decided not to reconsider the unit-of-account guidance in other existing pronouncements in this project.

Matters Discussed and Decisions Reached

Ms. MacDonald summarized the issues listed on the attachment. She pointed out that some of those issues relate to Board decisions made as part of its former Statement 107 replacement project, which, if adopted, would result in a significant change to practice. She said that because the composition of the Board has since changed, the staff thought it appropriate for the current Board to reconsider those decisions at this time.

1. Phase 1 Scope Exclusions

Ms. MacDonald discussed the staff's proposal to exclude from the Phase 1 scope revenue recognition transactions covered under existing EITF and AICPA pronouncements that require an entity-specific or vendor-specific objective evidence (VSOE) of fair value measurement. She said that measurement issues relating to those transactions are being addressed in the revenue recognition project. She asked the Board whether it agreed with that staff proposal.

Mr. Trott clarified that a VSOE of fair value measurement concept is consistent with a fair value measurement concept, but that its application under existing EITF and AICPA pronouncements raises issues beyond the Phase 1 scope of this project. Ms. Schipper agreed, referring to the related “retail” versus “wholesale” market issues that the Board is addressing for those (and other) transactions in its revenue recognition project. Ms. Seidman added that the existing revenue recognition guidance includes a default for situations where VSOE does not exist (generally no revenue recognition), which would likely differ from the application of the fair value hierarchy.

All Board members agreed with that staff proposal.

2. Bid-Asked Spread Pricing Issues

Ms. McKenna discussed the Board’s December 2001 decision in the Statement 107 project that for financial instruments traded in active markets where prices are quoted in terms of bid and asked prices, the fair value measurement should be determined using the mid-point of the bid-asked spread. She pointed out that since that time, the Board decided to define fair value by reference to an exchange price, rather than an exit price. Also, the Board has received constituent input on that issue that refers to using bid prices for long positions and asked prices for short positions. She asked the Board whether it wishes to affirm (or reconsider) its December 2001 decision. She said that alternative approaches include (1) measurement within the bid-asked spread, provided the method used is consistently applied (the ASR No. 118 , *Accounting for Investment Securities by Registered Investment Companies*, approach) and (2) bid prices for long positions and asked prices for short positions (the IAS 39, *Financial Instruments: Recognition and Measurement*, suggested but not required approach).

Ms. Schipper referred to the new information that the Board has received from constituents through the valuation resource group (VRG) and field visits. She said that the new information supports using bid prices for long positions and asked prices for short positions, the IAS 39 suggested approach. However, because FASB Statements generally do not allow treatment alternatives, she supports requiring the IAS 39 suggested approach. Although requiring that approach would not result in full convergence, it would be directionally consistent with IAS 39. Batavik agreed.

Mr. Schieneman agreed with requiring the IAS 39 approach, but only for bid-asked spreads in active markets. He clarified that other valuation techniques would need to be considered for bid-asked spreads in less active markets (referring to Level 3 estimates).

Ms. Seidman referred to the exchange price principle under development in this project. She said that the principle is clear as it relates to bid-asked spread pricing issues, and she would not prescribe specific guidance in the standard. She acknowledged that the application may differ for different business activities, for example, market makers in securities, and found that result acceptable. She said that she supports providing limited guidance in the form of implementation guidance that is generally consistent with the IAS 39 suggested approach, which would not prohibit a preparer from using an alternative approach within the bid-asked spread. Mr. Herz agreed, but said that in the interest of convergence he would not object to requiring the IAS 39 suggested approach.

Mr. Trott said that the limited guidance suggested by Ms. Seidman would not necessarily be useful and that the Board should take a position on bid-asked spread pricing issues. He affirmed his previous view that a mid-point price is representative of a bargained exchange price because it considers prices at either end of the spread. However, in the interest of convergence he would not object to requiring the IAS 39 suggested approach. Crooch agreed.

For financial instruments traded in active markets where prices are quoted in terms of bid and asked prices, the Board voted 6-1 that the fair value measurements should be determined using bid prices for long positions and asked prices for short positions. Seidman objected.

3. Measurement of Restricted Securities

Ms. McKenna discussed the Board's April 2003 decision in the Statement 107 project to provide guidance for measuring the fair value of restricted securities—securities for which sale is restricted by governmental or contractual requirement issued by entities with freely traded securities identical in all respects except for the restriction. She said that at that meeting, the Board decided to refer to factors that should be included among those considered in the measurement, including the fair value and volatility of an unrestricted unit of the same security, the nature and duration of the restriction, and the risk-free interest rate.. These would supplement the SEC guidance in ASR 113, which establishes the general principle that the fair value of restricted securities depends on their inherent worth, without regard to the restricted feature, adjusted for any diminution in value resulting from the restrictive feature. She asked the Board whether additional guidance was needed for those measurements.

Ms. Schipper said that for those securities, it would not be feasible for the Board to develop additional guidance listing all of the factors that should be considered in the measurement. Instead, she suggested that the proposed fair value Statement incorporate the SEC guidance in ASR 113, which refers to methods generally inappropriate for those measurements. Although that SEC guidance already exists, it might be useful to include all of the relevant guidance in one place.

Mr. Batavik agreed. He said that this is a situation in which the principle that currently exists (in ASR 113) should apply.

Mr. Trott said that he would not object to not providing additional guidance, noting that for restricted securities for which there otherwise is an active market the discount is attributable only to the restriction (the lack of liquidity resulting from the inability to access that market for a specified period). He added, however, that he continues to have concerns that in some cases, the discount also might reflect other factors generally inappropriate for those measurements.

Ms. Seidman agreed that the SEC guidance in ASR 113 is useful, but suggested that the proposed fair value Statement merely refer, rather than incorporate, that guidance. Mr. Herz agreed.

All Board members agreed that for fair value measurements involving restricted securities, the existing SEC guidance in ASR 113 should continue to apply, as supplemented by the proposed guidance discussed by the Board in April 2003. The proposed fair value Statement should refer to that existing SEC guidance.

4. Unit of Account Issues

Ms. MacDonald said that for purposes of addressing unit-of-account issues, the staff focused separately on (a) financial instruments traded in active markets and (b) assets and liabilities not traded in active markets.

a) Financial Instruments Traded in Active Markets

Ms. MacDonald said that by way of background, at a public meeting in January 2003, the Board met with members of AcSEC's blockage factor task force to discuss a draft of a proposed SOP on block discounts. After that meeting, in connection with the Board's initiatives to realign the roles of U.S. standard setters (including AcSEC), the Board decided to address the issue of block discounts in its Statement 107 project. The Board last discussed that issue in March 2003. At that time, the Board decided to retain the principle in Statement 107, which establishes that the unit of account for financial instruments traded in active markets is the individual trading unit and prohibits a fair value measurement using a block discount. That decision would effectively eliminate the exception in the AICPA industry audit guides for broker dealers and investment companies. She said that since that time, the Board has received constituent input that supports using block discounts (principally, from broker dealers). However, that information does not raise issues that were not previously considered by the Board in reaching its March 2003 decision. She asked the Board whether it wishes to affirm (or reconsider) its March 2003 decision.

Mr. Schieneman said that the Board should reconsider that decision. He said that a fair value measurement should reflect an entity's business activity, which, for block traders, would allow a block discount. He acknowledged that for most fair value measurements, quoted prices in active markets are considered reliable and verifiable, but said that for block traders such measurements are not representationally faithful. He said that block discounts affect only a limited number of entities and that, for practical reasons, the Board should make an exception to requiring a PxQ measurement for those entities.

Ms. Seidman agreed, but said that she views the issue as more of a reference market issue than a unit-of-account issue. She said that while block traders often have access to both the retail and block markets, they typically transact in the block (dealer) market. She acknowledged that her view could be inconsistent with the most advantageous market principle under development in this project.. Mr. Herz agreed, adding that the retail markets are not always the most favorable markets as there are other associated transaction costs that entities consider when buying and selling within such markets such as hedging costs. He said that for those entities, a PxQ measurement does not reflect rational market behavior.

Mr. Trott agreed with Ms. Seidman, but only to the extent of focusing the issue on the appropriate reference market. Beyond that, he said that the appropriate reference market should not depend on the market in which an entity intends to transact. He further said that allowing block discounts raises significant issues about the relevance of the resulting measurement. Ms. Schipper agreed, summarizing the approaches previously considered by the Board in determining whether to allow block discounts—an "intent-based" approach, a "facts-and-circumstances" approach, and a "discretionary" approach. She said that each of those approaches raises significant issues about the relevance of the resulting measurement.

The Board voted 4-3 to affirm its March 2003 decision to retain the principle in Statement 107, which establishes that the unit of account for financial instruments traded in active markets is the individual trading unit and prohibits a fair value measurement using a block discount. That decision would require conforming changes to the AICPA industry guides for broker dealers and investment companies. Herz, Schieneman, and Seidman objected.

b) Assets and Liabilities Not Traded in Active Markets

Ms. MacDonald said that for assets and liabilities not traded in active markets, the unit-of-account guidance in existing pronouncements differs. She said that given those differences, the staff believes that a general unit-of-account principle is needed, but that because related issues are pervasive, such a principle should be developed in a separate project that could broadly consider those issues in the context of recognition, measurement, and display. She asked the Board for its views on whether and, if so, how to proceed with unit-of-account issues in this project.

Ms. Schipper encouraged the Board to consider unit-of-account issues in a separate project, preferably at the concepts level, as a basis for determining whether those issues are ones that are so intractable that they can only be addressed on a standard-by-standard basis.

Mr. Trott agreed that this project is not the project within which to develop a general unit-of-account principle, but noted that related issues might need to be addressed as a basis for clarifying certain fair value measurements. He agreed, however, that addressing those issues should not lead to a reconsideration of the unit-of-account guidance in existing pronouncements.

All Board members generally agreed that the Board should not reconsider the existing unit-of-account guidance for assets and liabilities not traded in active markets in this project.

Follow-up Items:

None.

General Announcements:

None.

Board Handout
Fair Value Measurement

At its November 19, 2003 meeting, the Board will discuss Phase 1 scope and codification issues identified in the review of existing pronouncements with fair value measurement requirements (including EITF, AICPA, and SEC pronouncements). The discussion will focus on the issues referred to below.

1. Phase 1 Scope Exclusions

The Board will discuss whether to exclude from the Phase 1 scope existing pronouncements that relate to revenue recognition transactions under consideration in the revenue recognition project that are measured using entity-specific or vendor-specific objective evidence (VSOE) of fair value (including EITF Issue No. 00-21, SOP 97-2, SOP 98-9). The Board previously decided to exclude from the Phase 1 scope existing pronouncements that relate to leasing and stock-based compensation transactions.

2. Bid-Asked Spread Pricing Issues

At its December 19, 2001 meeting in the FAS 107 project, the Board decided that if a quoted market price is represented by a bid-asked spread, rather than a single transaction price, and the spread is created by firm offers to buy or sell in an active market, the mid-point of the spread must be used to estimate fair value. The Board will discuss whether to affirm that decision and, if so, the scope of conforming changes to other existing pronouncements (SEC and AICPA). Other approaches include a measurement within the bid-asked spread that would permit but not require bid prices for assets and asked prices for liabilities (the approach suggested in IAS 39).

3. Measurement of Restricted Securities

At its April 9, 2003 meeting in the FAS 107 project, the Board decided that the following factors should be among those considered in measuring the fair value of restricted securities: the fair value and volatility of an unrestricted trading unit of the same security, the nature and duration of the restriction, and the risk-free interest rate. Restricted securities refer to securities for which sale is restricted by governmental or contractual requirement issued by entities with freely traded securities identical in all respects except for the restriction. For those securities, the Board will discuss the need for additional measurement guidance.

4. Unit of Account Issues

The unit of account describes the asset (or liability) accounted for under a particular pronouncement and the level at which the asset (or liability) should be aggregated (or disaggregated) for purposes of applying all (or some) of the provisions of the pronouncement. For fair value measurements, it describes "what" is being measured.

a. Financial Instruments Traded in Active Markets

At its March 5, 2003 meeting in the FAS 107 project, the Board decided to prohibit using block discounts in measuring the fair value of a large position of unrestricted securities traded in an active market, thereby affirming the principal in FAS 107 that for financial instruments traded in an active market, the unit of account is the individual trading unit and fair value is measured as PxQ. The Board will discuss whether to affirm that decision and, if so, the scope of conforming changes to other existing pronouncements (AICPA).

b. Other Assets and Liabilities Measured at Fair Value

The Board will discuss whether to develop in this project a principle(s) that would define the unit of account for other assets and liabilities measured at fair value, considering the related guidance that exists for many of those assets and liabilities under other pronouncements, including the following:

- Business acquired in a business combination (FAS 141, EITF Issue No. 98-2, EITF Issue No. 02-17)
- Acquired intangible assets (FAS 141, EITF Issue No. 02-17)
- Goodwill (FAS 141, EITF Topic No. D-101)
- Financial instruments not traded in active markets (FAS 107)
- Impaired loans (FAS 114, EITF Topic No. D-80)
- Impaired long-lived assets held and used (FAS 144)
- Long-lived assets held for sale (FAS 144)
- Mortgage loans held for sale (FAS 65)
- Asset retirement obligations (FAS 143)
- Guarantees (FIN 45)
- Expected losses of a VIE (FIN 46)
- Employee benefit plans (FAS 87, FAS 106).