

MINUTES



To: Board Members
From: FVM Team (Goetsch, ext. 447)
Subject: Minutes of the March 15, 2006, FVM Board Meeting **Date:** March 27, 2006
cc: Bielstein, L. Smith, Fair Value Team, Revenue Recognition Team, Business Combinations Team, McBeth, Polley, Gabriele, Carney, Mahoney, Sutay, Leisenring (IASB), Nelson (IASB), 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: Draft of a final Statement on Fair Value Measurements : Initial measurement guidance, effective date, and timing

Basis for Discussion: Memorandums dated February 8, 2005, February 9, 2006, and March 1, 2006, and audience handout (attached)

Length of Discussion: 10:15 a.m. to 12:15 p.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, Goetsch, Lott, Smith, Thuener, and Todorova

Outside participants: None

Summary of Decisions Reached

The Board clarified aspects of the guidance in the October 21, 2005, draft of a final Statement on fair value measurements (FVM Working Draft). The Board clarified that:

1. A fair value measurement assumes an orderly transaction to sell or otherwise dispose of an asset or transfer a liability in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.
2. The inputs referred to within the fair value hierarchy are market inputs that reflect the assumptions that market participants in the principal (most advantageous) market would use in pricing an asset or liability and differ with respect to the extent to which they are observable. The fair value hierarchy gives the highest priority to observable market inputs (Level 1) and the lowest priority to unobservable market inputs (Level 3).
3. A fair value measurement must include all of the assumptions that market participants in the principal (most advantageous) market would consider in pricing the asset or liability, including assumptions about risk if the measurement is based on unobservable market inputs.
4. In many cases, a transaction price will represent the fair value of an asset or liability at initial recognition, but not presumptively.

The Board affirmed its previous decision not to re-expose the June 2004 FASB Exposure Draft, *Fair Value Measurements*, (FVM ED). Instead, the Board decided to delay the effective date of the final FVM Statement. The final FVM Statement will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged if the reporting entity has not yet issued financial statements (annual or interim) for the fiscal year in which the final FVM Statement is initially applied.

Objective of Meeting

The purpose of the meeting was for the Board to discuss clarifications to the FVM Working Draft and the timing of a final FVM Statement.

Matters Discussed and Decisions Reached

Reference Market Principle

1. Ms. MacDonald explained that, based on related input, the reference market principle, and its use in the definition of fair value, created confusion in determining how it should be applied. To more clearly convey that principle, she recommended that the Board:

- a. Clarify the reference market principle in the context of the principal market or, in the absence of a principal market, the most advantageous market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability
- b. Remove the references to “reference market” from the definition and elsewhere within the FVM Statement.

2. All Board members agreed with the staff recommendation.

Market Participant Assumptions in Fair Value Measurements

3. Ms. MacDonald explained that the FVM Working Draft emphasizes that a fair value measurement should consider the assumptions that market participants would use in pricing an asset or liability (market inputs). She recommended that the Board:

- a. Clarify that all inputs referred to in the fair value hierarchy are market inputs that differ with respect to whether they are observable or unobservable.
- b. Refer to unobservable market inputs, rather than entity inputs, to more clearly convey the requirement for a fair value (versus an entity-specific) measurement within Level 3.

4. Ms. MacDonald added that the related guidance would refer to unobservable market inputs as inputs that reflect the reporting entity’s assumptions of market inputs, developed based on its own data, adjusted to exclude factors specific to the reporting entity if information is available that indicates that market participants would use different assumptions. Further, it

would clarify that in pricing the asset or liability, the valuation technique should consider the amount of any pricing adjustments that a market participant (buyer) would demand for the risk relating to unobservable market inputs.

5. All Board members agreed with the staff recommendation. Ms. Schipper stated that the related guidance should emphasize that the valuation technique used to measure fair value should consider all of the assumptions a market participant would use, not just those assumptions that are easily accessible. Ms. Seidman added that, when looking to unobservable market inputs, the focus must remain on arriving at a hypothetical exit price.

Fair Value Measurements at Initial Recognition

6. Ms. MacDonald explained that the FVM Working Draft establishes that for an asset or liability that is acquired or assumed in an exchange transaction, the transaction price (an entry price) should be presumed to represent the fair value of the asset or liability (an exit price) at initial recognition of the asset or liability. She recommended that the Board clarify that, in many situations, the transaction price will represent the fair value of the asset or liability, but not presumptively, to more clearly convey the requirement for an exit price (versus an entry price). She stated that the related guidance would refer to the examples of factors an entity should consider in determining whether a transaction price represents fair value included in the audience handout.

7. All Board members agreed with the staff recommendation. Ms. Schipper pointed out that the examples referred to by the staff are not intended to be an all inclusive listing of all such examples and, therefore, should be clearly presented as examples.

8. Ms. Seidman stated that she would prefer to change the emphasis of the related guidance so that it conveys that the objective is to replicate the price in an exchange transaction for the asset or liability. Therefore, if there is an exchange transaction for the asset or liability, the price in the transaction should be presumed to represent the fair value of the asset or liability absent evidence to the contrary, similar to the related guidance in FASB Concepts Statement No. 7,

Using Cash Flow Information and Present Value in Accounting Measurements. She stated that an emphasis on entry versus exit prices rather than on transaction (exchange) prices would be confusing in practice.

9. Mr. Trott disagreed with Ms. Seidman. He stated that an emphasis on transaction (exchange) prices does not clearly convey the exit price objective encompassed within the definition of fair value.

10. Mr. Herz referred to the need to consider other existing accounting pronouncements that refer to fair value measurements using transaction prices. In particular, he raised concerns about the potential change to practice under those Statements. Ms. MacDonald explained that of the existing accounting pronouncements that require fair value measurements at initial recognition, the transaction price presumption is explicitly incorporated in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. The Board previously agreed to leave that guidance unchanged because it is addressing related issues in the revenue recognition project.

Effective Date and Timing of the Final FVM Statement

11. Ms. MacDonald explained that, based on recent discussions, the final FVM Statement would be effective for financial statements issued for fiscal years beginning after November 15, 2006, and interim periods within those fiscal years, with early application encouraged. She recommended that the Board:

a. Delay the effective date by one year, and encourage early application only if the reporting entity has not yet issued financial statements (annual or interim) for the fiscal year in which the final FVM Statement is initially applied.

b. Affirm its earlier decision not to re-expose the FVM ED. In that regard, Ms. MacDonald referred to the significant input received from constituents throughout the redeliberations process.

12. All Board members agreed with the staff recommendation, subject to external reviewer input on a revised working draft of a final FVM Statement. Mr. Herz suggested that the staff expand the list of external reviewers to include representative constituent groups and solicit input on specific issues.

13. Mr. Trott noted that recent constituent communications focusing on the FASB fair value project raise IASB convergence issues. He asked Mr. Leisenring about the status of the IASB fair value measurement project. Mr. Leisenring explained that the IASB plans to separately expose the FASB FVM Statement after the FASB finalizes the Statement and the IASB has the opportunity to fully consider and discuss the Statement.

OTHER ISSUES

Statement 141

14. Ms. MacDonald explained that recent constituent communications focusing on the upcoming FASB FVM Statement indicate concerns about the application of the market participant notion under existing accounting pronouncements, in particular, FASB Statement No. 141, *Business Combinations*. She asked Board members for their views on whether to exclude Statement 141 from the scope of the final FVM Statement pending completion of the business combinations project.

15. The Board decided not to exclude Statement 141 from the scope of the final FVM Statement. Ms. Shipper noted that fair value is one of several measurement attributes in Statement 141. Moreover, fair value is only used in certain situations. She stated that in those situations in which fair value is used, the guidance in the final FVM Statement should apply. Mr. Batavick agreed, stating that the delayed effective date is sufficient to alleviate potential implementation issues under the final FVM Statement.

Disclosure Issues

16. Ms. Thuener updated Board members on progress to date with respect to disclosure issues. She stated that the staff has discussed with some constituents disclosures that would require a reconciliation of beginning and ending balances of assets and liabilities measured at fair value on a recurring basis within Level 3. She explained that the reconciliation would distinguish the change relating to the measurement of the assets and liabilities (from inception to settlement) from the change relating to cash transactions (for example, cash

settlements) and show reclassifications in and out of Level 3. Also, the staff is considering ways to segregate the income statement effect of fair value measurements within Level 3 (potentially subject to measurement error). The disclosures would focus on assets and liabilities measured within Level 3 that are still held at the reporting date.

20. Mr. Young stated that the fair value disclosures are important. He suggested that the staff obtain input from representative users (analysts) on the disclosures, as well as the related issue of whether to establish a minimum reliability threshold for purposes of determining whether to recognize the income statement effect of fair value measurements within Level 3. Other Board members agreed.

Follow-up Items:

14. None.

General Announcements:

15. None.



**Board Meeting Handout
FAIR VALUE MEASUREMENT PROJECT
March 15, 2006**

The Board will discuss clarifications to the guidance in the October 21, 2005 working draft of FASB Statement No. 15X, *Fair Value Measurements*, (FVM Working Draft) proposed by the staff and the timing of a final FVM Statement.

1. REFERENCE MARKET PRINCIPLE

In the FVM Working Draft, the definition of fair value refers explicitly to the “reference market.” The Board will discuss whether to:

- a. Clarify the reference market in the context of the principal market or, in the absence of a principal market, the most advantageous market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability
- b. Remove the references to “reference market” from the definition and elsewhere within the FVM Statement.

2. MARKET PARTICIPANT ASSUMPTIONS IN FAIR VALUE MEASUREMENTS

The FVM Working Draft clarifies that a fair value measurement should consider the assumptions that market participants would use in pricing an asset or liability (market inputs). To emphasize the requirement for market inputs, the Board will discuss whether to clarify the related guidance in the fair value hierarchy to:

- Distinguish between observable market inputs (developed based on market data obtained from sources independent of the reporting entity) and unobservable market inputs (inputs that reflect the reporting entity’s assumptions of market inputs, developed based on its own data, adjusted to exclude factors specific to the reporting entity if information is available that indicates that market participants would use different assumptions) and
- Refer to unobservable market inputs (instead of entity inputs) to more clearly convey the requirement for a fair value measurement (versus an entity-specific measurement) within Level 3.

With respect to market inputs, the Board will discuss the need to further emphasize that a valuation technique used to measure fair value should include all of the assumptions market participants would use in pricing the asset or liability and exclude factors specific to the reporting entity if information is available that indicates that market participants would exclude those factors. In that case, the reporting entity should consider the extent to which the measurement is based on unobservable market inputs and any pricing adjustments a market participant (buyer) would demand to assume the related risk, as well as other factors specific to the asset or liability.

3. FAIR VALUE MEASUREMENTS AT INITIAL RECOGNITION

The FVM Working Draft establishes that for an asset or liability that is acquired or assumed in an exchange transaction, the transaction price (an entry price) should be presumed to represent the fair value of the asset or liability (an exit price) at initial recognition of the asset or liability. The Board will reconsider that transaction price presumption in the context of the exit price objective encompassed within the definition. Specifically, the Board will discuss whether to clarify that, in many situations, the transaction price will represent the fair value of the asset or liability (but not presumptively), emphasizing that in making that determination, the reporting entity should consider facts and circumstances specific to the transaction and the asset or liability, including the following:

- a. Whether the number of elements (unit of account) represented by the transaction price is different from the unit of account for the asset or liability measured at fair value (for example, if the transaction is a multiple-element transaction and the asset or liability being measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs)
- b. Whether the transaction is between related parties
- c. Whether the transaction occurs under duress or the seller is forced to accept the price in the transaction because of urgency (for example, a forced liquidation or distress sale where a particular entity is experiencing financial difficulty)
- d. Whether the market in which the transaction occurs is different from the market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability

4. EFFECTIVE DATE AND TIMING OF FINAL FVM STATEMENT

The FVM Working Draft, as recently revised by the Board, is effective for financial statements issued for fiscal years beginning after November 15, 2006, and interim periods within those fiscal years, with early application encouraged. Subject to related disclosures (to be discussed at a future meeting), the Board will discuss:

- a. Whether to re-expose the June 2004 Exposure Draft, *Fair Value Measurements*, considering the input received from constituents as part of the redeliberations process and/or delay the effective date of the FVM Statement (for example, by one year)
- b. Whether to limit early application of the FVM Statement to situations in which the reporting entity has not yet issued financial statements (annual or interim) for the fiscal year in which the FVM Statement is initially applied.

5. OTHER ISSUES

The staff will seek views from Board members on other issues that should be considered in finalizing the FVM Statement, including the following:

- a. Scope issues, in particular, the need for additional scope exclusions to allow for concerns about applying a market participant approach under some existing accounting pronouncements, including FASB Statement No. 141, *Business Combinations*
- b. Disclosure issues, considering the need to revise the proposed disclosures relating to recurring fair value measurements that fall within Level 3 (in their entirety).