

MINUTES



To: Board Members
From: Kapko (ext. 317)
Subject: Minutes of the March 2, 2005 FVM Board Meeting **Date:** March 9, 2005
cc: Bielstein, L. Smith, Petrone, Fair Value Team, Revenue Recognition Team, Business Combinations Team, Larson, Swift, Polley, Gabriele, Getz, Thompson, Mahoney, Leisenring (IASB), J. Paul (IASB), G. Ryltsova (IASB), P. Martin (CICA), FASB Intranet

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Topic: Proposed FASB Statement, *Fair Value Measurements*—definition of fair value and its application to liabilities and related issues

Basis for Discussion: Memorandums 1 and 2 dated February 11, 2005, and Memorandum 3 dated February 16, 2005, and audience handout (attached)

Length of Discussion: 10:15 a.m. to 12:00 p.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: MacDonald and Thuener

Other staff at Board table: Bielstein, Kapko, McBride, and E. Smith

Outside participants: None

Summary of Decisions Reached

The Board continued redeliberations of the proposed FASB Statement, *Fair Value Measurements* (FVM), focusing on the definition of fair value and its application to liabilities and related issues. The Board reached the following decisions:

1. For a liability, fair value should reflect the amount that would be paid by the reporting entity to transfer the liability to a willing third party of comparable credit standing (layoff amount). Accordingly, liability remeasurements at fair value should include the effect of changes in the entity's credit standing so that the estimate reflects the amount that would be observed in an exchange (layoff) between willing parties of the same credit quality, considering the terms of any collateral and other credit enhancements included in the contract for the liability being measured. At a future meeting, the Board plans to consider whether to add to its agenda a separate project to address concerns about including the effect of credit downgrades in those remeasurements required under existing pronouncements, in particular, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
2. At initial recognition where there is an actual transaction for the asset or liability being measured, the transaction price provides presumptive evidence of the fair value of that asset or liability. That presumption can be rebutted in certain circumstances where there is persuasive evidence to the contrary.
3. In circumstances where the transaction price presumption is rebutted, guidance specifying how to recognize the difference between the transaction price and the initial estimate of fair value should be provided in individual pronouncements that require fair value measurements, not in the FVM Statement. At a future meeting, the Board plans to consider whether to add to its agenda a separate project to address related recognition issues under existing pronouncements, in particular, 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."
4. In the absence of observable market data, fair value estimates may be developed using entity data as a practical expedient within Level 4 of the fair value hierarchy, as previously revised.

Objective of Meeting:

The principal objective of the meeting was to clarify the fair value measurement approach for liabilities.

Matters Discussed and Decisions Reached:

Fair Value Measurements and Liabilities

1. Ms. MacDonald said that in its previous discussions, the Board agreed, subject to further consideration, that the fair value of a liability should reflect a layoff amount, that is, the amount that would be paid by the reporting entity to transfer the liability to a willing third party of comparable credit standing. She said that having further considered that issue, the staff recommends that the Board affirm that decision.

2. All Board members agreed with the staff recommendation. Ms. Seidman said that the practical effect of affirming that decision depends on the decisions on the remaining issues, in particular, whether at initial recognition a transaction price provides presumptive evidence of fair value. Mr. Trott agreed.

Transaction Prices and Initial (Day 1) Fair Value Measurements

3. Ms. MacDonald explained that within generally accepted accounting principles (GAAP), there is a general presumption that at initial recognition the price in an actual transaction for an asset or liability provides evidence of the fair value of that asset or liability. She said that the FVM Exposure Draft (ED) incorporates that presumption, but implicitly, referring to paragraph 5 of the FVM ED which discusses the need to estimate fair value *in the absence of an actual transaction*. Accordingly, as noted by some respondents, the FVM ED is ambiguous with respect to whether an actual transaction price versus an observed price within the fair value hierarchy should be used for an initial fair value estimate. Ms. MacDonald said that in response, the staff recommends that the Board (a) clarify that at initial recognition where there is an actual transaction for the asset or liability being measured, the transaction price provide presumptive evidence of the fair value of that asset or liability and (b) clarify circumstances in which that presumption would be rebutted as in items 2(a) and (b) of the audience handout (attached).

4. All Board members agreed with the staff recommendation, subject to clarification of the circumstances in which the transaction price presumption would be rebutted.

Item 2(a)

5. Mr. Herz said that instead of referring to marketplace participants that are “not equally knowledgeable,” he would prefer to incorporate the notion of rational (versus irrational) economic behavior, which is central to the definition of fair value. Otherwise, one could infer that in cases where both parties to a transaction are knowledgeable, the transaction price presumption would be rebutted whenever one party is *more* knowledgeable than the other. Ms. Seidman agreed. She suggested that item 2(a) be expressed as a general principle without any incremental prescriptive guidance.

Item 2(b)

6. Ms. Schipper clarified that with respect to a contractual revenue arrangement, that is, a “bundled” multiple element transaction, the transaction likely would include other elements that are immediately consumed (market access elements). Accordingly, the transaction price would represent a payment for more than just the stand-alone liability (or contractual asset).

7. Mr. Trott elaborated on examples of multiple element transactions, referring to an example discussed by the Board in its electrical waste project where the price in a single transaction for replacement equipment also requires the buyer to assume the related asset retirement obligation (ARO)—two separate elements. He noted that in that transaction, the transaction price would measure the fair value of both of those elements in the aggregate.

8. Ms. Seidman agreed that in a multiple elements asset or liability transaction, the transaction price provides presumptive evidence of the fair value of the transaction as a whole (in the aggregate), but not necessarily the fair value of the stand-alone asset or liability. In that regard, she noted that any number of transactions involving both assets and liabilities could be multiple element transactions (for example, transactions ranging from a business combination to a

contractual revenue arrangement). Accordingly, there is no need to specify in the FVM Statement transactions that might (or might not) be multiple element transactions. Rather, that measurement principle should be expressed as a general principle and separately considered under other pronouncements that specify whether a particular transaction is a multiple element transaction and, if so, the appropriate unit of account for the transaction, that is, whether the elements should be measured together in the aggregate or separately on a stand-alone basis

Other Factors

9. Mr. Trott added that in determining whether the transaction price presumption is rebutted by an entity's estimate of fair value, he would consider where within the fair value hierarchy the entity's estimate falls. He explained that an entity's estimate based on a price for an identical asset or liability in an active market within Level 1 would provide more persuasive evidence than an entity's estimate based on significant entity inputs within Level 4. Mr. Trott emphasized, however, that the transaction price is primary and that in all cases, there must be persuasive evidence in order to rebut the presumption. Ms. Seidman further emphasized that a transaction price might be different from an observed price within Level 1, but that the difference, in and of itself, should not rebut the transaction price presumption. In that case, factors specific to the transaction should be considered as a basis for determining whether the transaction is one encompassed within the definition of fair value, as indicated in item 2(a).

10. Mr. Young emphasized that the estimate of fair value should be based on the best available evidence, whether or not the transaction price presumption is rebutted.

Day 1/Day 2 Recognition Guidance

11. Ms. MacDonald explained that Issues 3 and 4 identified on the audience handout consider the need to provide guidance specifying how to recognize a difference between a transaction price and the initial estimate of fair value in circumstances where the transaction price presumption is rebutted. In that

regard, the threshold issue is whether the FVM Statement or other pronouncements that require fair value measurements should provide that recognition guidance.

12. All Board members agreed that because the FVM Statement is a Statement on “how” to measure fair value when fair value is required by another Statement, recognition guidance is beyond the scope of the Statement. Thus, that guidance should be provided in individual pronouncements that require fair value measurements.

13. At the same time, however, Ms. Seidman and other Board members acknowledged the related practice issues under existing pronouncements that require fair value measurements, in particular, Issue 02-3. The Board asked the staff to develop an agenda request for a separate project to address those issues through a Board-directed FSP.

Credit Standing and Liability Remeasurements

14. Ms. Thuener said that as a follow-up to previous discussions, the staff would like to discuss the inclusion of credit standing in fair value measurements, in particular, liability remeasurements. Respondents have expressed concerns about including changes in the effect of an entity’s credit in those remeasurements because they would result in the reporting of “gains” for credit downgrades and “losses” for credit upgrades.

15. Ms. Thuener said that having further considered various aspects of the credit standing issue, the staff continues to believe that credit is an essential element of a fair value measurement and should be included in the definition of fair value within the FVM Statement. She said that at this time, the threshold issues are (a) whether to include the credit standing concept in the definition of fair value within the FVM Statement and (b) if so, whether to consider practical limitations on the application of the credit standing concept for liability remeasurements at fair value to allow for situations in which an entity might not have the ability to realize (monetize) the effect of credit downgrades. A related issue is whether practical limitations, if any, should be specified in the FVM

Statement or other pronouncements that require liability remeasurements at fair value.

16. All Board members agreed with the staff recommendation to include the credit standing concept in the definition of fair value within the FVM Statement, clarifying that liability remeasurements at fair value should include the effect of changes in the entity's credit standing so that the estimate reflects the amount that would be observed in an exchange (layoff) between willing parties of the same credit quality (as indicated in footnote 4 to paragraph 5 of the FVM ED). In addition, Ms. Seidman reiterated the Board's earlier clarification that in determining the effect, an entity should consider the terms of any collateral and other credit enhancements included in the contract for the liability being measured.

17. With respect to realizability and other issues, the Board agreed to separately consider the need for practical limitations on the application of the credit standing concept in individual pronouncements that require liability remeasurements at fair value.

18. In that regard, Mr. Trott said that realizability is not a useful criterion. Instead, realizability issues are measurement issues that should be considered when determining whether fair value or some other measurement attribute is appropriate.

19. Ms. Seidman agreed that realizability issues might affect the selection of the appropriate measurement attribute. In that regard, she referred to situations in which a borrower is experiencing financial difficulty. She said that because the only way to realize the gain from deterioration is to renegotiate the terms with the creditor, those situations raise questions about whether the debtor has the financial ability to borrow at current market terms and whether the creditor would be expected to make a concession. Accordingly, the elements of the fair value definition (which requires that marketplace participants have the financial ability to currently transact) might no longer be met. In that case, the fair value measurement attribute would no longer be applicable. She suggested that as an interim step, the FVM Statement indicate that in situations in which an entity is

experiencing financial difficulty, there might come a time when fair value is no longer the appropriate measurement attribute. Similarly, Mr. Batavick suggested that in the FVM Statement, the basis of conclusions explain that although the Board chose not to consider respondents' realizability concerns in the Statement, it plans to separately consider those concerns in individual pronouncements.

20. Ms. Schipper observed that the definition of fair value does not require that an entity currently have the ability to settle its liabilities. She would continue to include the effect of changes in the entity's credit standing in liability remeasurements at fair value until such time as the entity is no longer a going concern. She emphasized that the objective of a fair value measurement is timely recognition of changes in economic phenomena, including but not limited to changes in credit standing. A fair value measurement provides timely recognition of those changes in the income statement.

21. Ms. Seidman referred to the need to address realizability issues in situations in which a borrower is experiencing financial difficulty under existing pronouncements that require liability remeasurements at fair value, in particular, Statement 133. She suggested that the Board address those issues in a separate project. Other Board members agreed and asked the staff to develop an agenda request for a separate project to address those issues through a Board-directed FSP.

Level 4 Estimates

22. Ms. MacDonald said that in its previous discussions, the Board affirmed its decision in the FVM ED to specify that in the absence of observable markets and (or) observable market inputs, "hypothetical" market prices should be replicated using entity inputs as a practical expedient. She noted, however, that since that time, some have raised concerns about including that hypothetical construct within the fair value framework (Level 4 of the fair value hierarchy, as revised). In view of those concerns, Ms. MacDonald said that the staff seeks the Board's view of whether it wishes to reaffirm that decision and, if so, whether Level 4 estimates should be communicated as fair value estimates. She said that for the

reasons previously discussed, the staff recommends that the Board retain Level 4 as a practical expedient for a fair value measurement.

23. All Board members agreed with the staff recommendation. Mr. Herz reiterated his concerns about requiring “hypothetical” fair value measurements. He said that while he would prefer to re-label Level 4 estimates as something other than fair value, this is not the project within which to develop alternative “default” measurement attributes. The Board will consider those measurement issues at the concepts level in its conceptual framework project.

Follow-up Items:

24. The Board asked the staff to develop agenda requests for separate projects to address related issues under existing pronouncements, in particular, Issue 02-3 (recognition issues) and Statement 133 (credit standing issues).

General Announcements:

25. None.



Board Meeting Handout

ATTACHMENT

FAIR VALUE MEASUREMENT PROJECT
March 2, 2005 Board Meeting

At the March 2, 2005 Board meeting, the Board will continue redeliberations of the proposed FASB Statement, *Fair Value Measurements* (FVM), focusing on the definition of fair value and its application to liabilities and related issues.

1. Fair Value Measurements and Liabilities

Does the Board support its earlier tentative decision in the FVM project that for a liability, fair value should reflect the amount that would be paid by the reporting entity (obligor) to transfer the liability to a willing third party of comparable credit standing (layoff amount)?

The Board will consider whether to affirm its earlier decision clarifying the fair value measurement objective for a liability. That decision is consistent with the view that because a liability is a present obligation to others that can only be settled (and, thus, leaves an entity little or no discretion to avoid the future sacrifice of assets), the fair value of a liability should reflect its settlement (layoff amount) considered from the perspective of a marketplace participant—*that is, the market's estimate of future net cash outflows assuming rational economic behavior.*

2. Transaction Prices and Initial (Day 1) Fair Value Measurements

Should the FVM Statement incorporate the general presumption within GAAP that at initial recognition, the price in an actual transaction for the asset or liability being measured provides evidence of the fair value of that asset or liability? If so, should the FVM Statement clarify that at initial recognition where there is an actual transaction for the asset or liability being measured, the fair value hierarchy applies only if the transaction price presumption is rebutted and provide examples of situations in which the presumption would be rebutted?

The FVM ED incorporates the transaction price presumption but implicitly, not explicitly. The Board will consider whether the FVM Statement should incorporate the transaction price presumption explicitly, clarifying that at initial recognition where there is an actual transaction for the asset or liability being measured, the fair value hierarchy applies only if the presumption is rebutted. The Board also will consider situations in which the transaction price presumption would be rebutted, including the following:

- a. The price is negotiated in a transaction that is not encompassed within the definition of fair value. For example, the transaction (1) is not arm's-length, (2) occurs under duress, or (3) is between marketplace participants that are not equally knowledgeable.
- b. The transaction is a contractual revenue arrangement that gives rise to a liability (if the contract is prepaid) or a contract asset (if the contract is not prepaid). The contract price provides presumptive evidence of the fair value of the arrangement in the aggregate but not the stand-alone liability or contract asset. Absent evidence to the contrary, the contract price and the fair value of the liability (layoff amount) or asset are different.

3. Day 1 Recognition Guidance

Should the FVM Statement or other pronouncements provide guidance for recognition of a difference that results in situations in which the transaction price presumption is rebutted (Day 1 difference)?

Day 1 recognition approaches include the following:

- a. Include the Day 1 difference in the measurement of the related asset or liability.
- b. Recognize the Day 1 difference in earnings.
- c. Establish a Day 1 (market-based) reliability threshold for revenue recognition within the fair value hierarchy (for example, within Level 3) and recognize the Day 1 difference in earnings if the threshold is met. Otherwise, defer the Day 1 difference.

Absent Day 1 recognition guidance in the FVM Statement, the Board will consider the need to separately provide related guidance under existing pronouncements. In particular, the Board will focus on those pronouncements in which revenue transactions give rise to liabilities that are measured at "fair value" using a transaction price (an incurred amount) that might not represent a layoff (settlement) amount (EITF Issue 02-3, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*).

4. Day 2 Recognition Guidance

If applicable, should the FVM Statement or other pronouncements provide guidance for recognition on Day 2 of a Day 1 difference that is deferred under item c (above)?

Day 2 recognition approaches include the following:

- a. Recognize the Day 1 difference in earnings when the specified Day 1 reliability threshold is met, in effect, establishing a single standard of reliability that would apply in all periods.

- b. Amortize the Day 1 difference in earnings.
- c. Defer the Day 1 difference.

Absent Day 1 recognition guidance in the FVM Statement, the Board will consider the need to separately provide related guidance under existing pronouncements where a Day 1 difference is recognized as under item c (above), in particular, EITF Issue 02-3.

5. Credit Standing and Liability Remeasurements

Does the Board support its earlier decision to include the credit standing concept within the FVM Statement, thereby elevating that concept to Level A GAAP? If so, should the FVM Statement or other pronouncements specify limitations on the application of that concept for liability remeasurements at fair value in certain specified circumstances?

Footnote 4 to paragraph 5 of the FVM ED states, “For a liability, the estimate of fair value should consider the effect of the entity’s credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality.”

In its previous discussions, the Board affirmed that for a liability, a measurement that excludes credit standing is not a “fair value” measurement. However, many respondents expressed concerns about the application of that credit standing concept within Level A GAAP for liability remeasurements at fair value (which would require entities to report “losses” for credit upgrades and “gains” for credit downgrades). In response, the Board will consider whether to affirm its decision to include the credit standing concept within the FVM Statement, thereby elevating that concept to Level A GAAP and, if so, whether the FVM Statement and/or other pronouncements should:

- a. Clarify that the effect of a change in the credit standing of the entity should be included in those remeasurements when the effect of the change is contemplated in the marketplace (where the effect is identifiable, measurable, and significant)
- b. Limit the application of the credit standing concept, as clarified, to situations in which the effect of the change is realizable, considering possible realizability indicators. Absent limitations on the application of the credit standing concept in the FVM Statement, the Board will consider the need to separately provide related guidance under existing pronouncements that require liability remeasurements at fair value (in particular, FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, Statement 133, and FASB Statements No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*). If applicable, the Board will consider possible default measurement attributes when credit is no longer included in a fair value measurement.

6. Level 4 Estimates

Does the Board support its earlier decision to include Level 4 within the fair value hierarchy? If so, how should the resulting estimates be communicated (disclosed)?

In its previous discussions, the Board affirmed its decision in the FVM ED to specify that in the absence of observable markets and/or observable market inputs, “hypothetical” market prices should be replicated using entity inputs as a practical expedient, subject to the requirements of other existing pronouncements. The Board decided to separately refer to those entity inputs within Level 4 of the fair value hierarchy, as revised. In response to concerns about the hypothetical construct within Level 4, the Board will consider whether to affirm its earlier decision to include Level 4 within the fair value hierarchy and, if so, whether Level 4 estimates should be communicated (disclosed) as fair value estimates or, alternatively, as fair value based estimates.