

**FAIR VALUE MEASUREMENT**

**Financial Accounting Standards Advisory Council  
September 2004**

**Background**

In June 2003, the Board decided to add a project to its agenda to improve guidance for measuring fair value, in part, in response to respondents' comments on the FASB Proposal, *Principles-Based Approach to U.S. Standard Setting* (discussed by Council members at the March 2003 FASAC meeting). The overall objective of the project is to improve guidance for measuring fair value. The near-term objective is to develop a Statement that will establish a framework for how to develop the fair value measurements that are currently required under other accounting pronouncements. A longer-term objective is to improve the related conceptual guidance, especially in the area of measurement reliability.

**Proposed Fair Value Statement**

In June 2004, the Board issued an FASB Exposure Draft of a proposed Statement, *Fair Value Measurements*, which is available on the FASB website (fasb.org). The proposed Statement provides guidance for how to measure fair value and would apply broadly to financial and nonfinancial assets and liabilities measured at fair value under existing authoritative accounting pronouncements. In developing the proposed Statement, members of the Board and staff consulted with Council members (June 2003), the Valuation Resource Group, the User Advisory Council, and other interested parties.

***Reason for Issuing the Proposed Statement***

Prior to the proposed Statement, there was limited guidance for applying the fair value measurement objective in generally accepted accounting principles (GAAP). That guidance was dispersed among the many pronouncements that require fair value measurements. Differences in that guidance created inconsistencies, adding to the complexity in GAAP. Also, many constituents have raised concerns about the ability to develop reliable estimates of fair value

Note: These materials are provided to facilitate understanding of the issues to be addressed at the September 23, 2004 FASAC meeting. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

in certain circumstances, in particular, in the absence of quoted prices. In response, the Board decided to develop a framework clarifying the fair value measurement objective and its application under other pronouncements that require fair value measurements. In developing the framework, the Board also considered the need for increased consistency and comparability in fair value measurements and enhanced disclosures about fair value measurements.

***Differences between the Proposed Statement and Current Practice***

The changes to current practice that would result from applying the proposed Statement relate principally to the methods for measuring fair value and expanded disclosure requirements. Specifically:

- The proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. It would prohibit the use of the other methods currently allowed under SEC ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies*.
- The proposed Statement would require that the fair value of restricted securities (securities for which sale is legally restricted by governmental or contractual requirements for a specified period) be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction. That guidance would apply to all restricted securities, including equity securities with restrictions that terminate within one year, which are included in the scope of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.
- The proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort. In all cases, the valuation techniques used for those estimates would emphasize relevant market inputs, including those derived from active markets.

- The proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, for using present value techniques to estimate fair value, thereby elevating that guidance to Level A GAAP. Thus, that guidance would apply under all pronouncements in which present value is used to estimate fair value, including APB Opinion No. 21, *Interest on Receivables and Payables*. The proposed Statement would not amend Concepts Statement 7. The Board expects to consider the need for amendments to Concepts Statement 7 in a subsequent phase of this project.
- The proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position, including information about the fair value amounts, how those fair value amounts were determined, and the effect of the remeasurements on earnings (including unrealized gains and losses). That information would be presented together with similar information disclosed under other pronouncements.

#### ***How the Changes in the Proposed Statement Would Improve Financial Reporting***

The proposed Statement establishes a framework for applying the fair value measurement objective in GAAP. The framework, which is expressed in “levels,” prescribes the use of available current market-based information. If that information is not available, entity-specific information and assumptions may be used. Improvements to financial reporting should result from increased consistency, reliability, and comparability. Related improvements should result from the expanded disclosures about the resulting fair value measurements, which should provide information that is useful to users of financial statements in assessing the effects of those measurements used in financial reporting. Also, the amendments made by the proposed Statement would advance the Board’s initiatives to simplify and codify the accounting literature.

#### ***How the Conclusions in the Proposed Statement Relate to the FASB’s Conceptual Framework***

In developing the fair value framework, the Board considered the qualitative characteristics discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. Those characteristics emphasize that providing comparable information enables users to identify similarities in and

differences between two sets of economic events. The fair value framework also clarifies and incorporates the guidance in Concepts Statement 7 for using present value techniques to estimate fair value.

The expanded disclosures about fair value remeasurements supplement the proposed fair value framework, providing information that is useful to present and potential investors, creditors, and others in making rational investment, credit, and similar decisions—an objective of financial reporting in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*.

The proposed fair value framework should provide the Board with a foundation for making improvements to the measurement guidance in its conceptual framework in a subsequent phase of this project.

### ***Costs and Benefits of Applying the Proposed Statement***

Although the guidance in the proposed Statement builds on current practice and requirements, some entities will need to make changes to comply with the requirements of this proposed Statement, thereby incurring one-time costs. However, the benefits from more reliable, consistent, and comparable information about the fair value measurements used in financial reporting should be ongoing.

### ***The Effective Date of the Proposed Statement***

The proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. Earlier application would be encouraged. The provisions of the proposed Statement are to be applied prospectively, except for the change in accounting principle relating to bid-asked spread measurements. For that change, the proposed Statement would require a retroactive transition approach applied by reporting a cumulative-effect adjustment.

## **Convergence**

The fair value project is not a joint project with the IASB. However, as part of its joint business combinations project, the IASB will consider whether it should separately expose some or all aspects of the guidance relating to the fair value hierarchy in the proposed Statement. The IASB plans to consider that issue at its September meeting.

## **Constituent Input**

The comment period ended on September 7. To date, we have received 80 comment letters. In large part, respondents generally support the proposed Statement, recognizing the need for improved guidance for the fair value measurements currently required in GAAP. However, many respondents have encouraged the Board to work with others (SEC and PCAOB) on related initiatives and to develop conceptual guidance focusing on issues of relevance and reliability before expanding the requirement for fair value measurements in GAAP.

On September 21, the Board will hold public roundtable meetings with some respondents to discuss certain significant issues raised in comment letters. Based on input received to date, the Board expects those issues to focus on the following:

- Fair value definition, in particular, the exchange price notion for assets and liabilities, the valuation premise, and use of blockage factors.
- Fair value hierarchy, in particular, possible revisions to the specified levels, Level 1 reference markets, Level 1 bid-asked spread measurements, and Level 3 valuation approaches (single versus multiple).
- Disclosures, in particular, disclosures of unrealized gains or losses.
- Other issues raised by respondents, including the interaction between the proposed Statement and EITF Issue No. 02-03, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," changes in

valuation techniques, and the need for additional implementation guidance for financial assets and liabilities versus other assets and liabilities.

- Effective date, in particular, the timing vis-à-vis issuance of a final Statement.

### **Discussion at the September Council Meeting**

At the September Council meeting, the Board plans to update Council members on issues raised by respondents. The Board also seeks additional input from Council members on issues raised in the proposed Statement, including those identified above.