MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Kapko (ext. 317)		
Subject:	Minutes of the November 30, 2004 FVM Board Meeting	**Date:**	December 3, 2004
cc:	Bielstein, L. Smith, Petrone, Fair Value Team, Revenue Recognition Team, Business Combinations Team, Lott, Swift, Polley, Gabriele, Getz, Thompson, Mahoney, Leisenring (IASB), J. Paul (IASB), G. Ryltsova (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: Significant issues raised by respondents to the proposed FASB Statement, *Fair Value Measurements*, relating to valuation premise and valuation techniques used to estimate fair value.

Basis for Discussion: Memorandums dated November 11, 2004, and November 17, 2004, and audience handout (attached)

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

Attendance:

Board members present:	Batavick, Crooch, Herz, Schieneman, Schipper, Seidman, and Trott
Board members absent:	None
Staff in charge of topic:	MacDonald, Pinson, and E. Smith
Other staff at Board table:	Bielstein, Munro, and Kapko
Outside participants:	Leisenring (IASB)

Summary of Decisions Reached:

The Board discussed significant issues raised by respondents to the proposed FASB Statement, *Fair Value Measurements* (FVM), relating to the valuation premise and valuation techniques used to estimate fair value.

The Board agreed that the valuation premise is necessary to determine the assumptions that marketplace participants would use with respect to whether and, if so, how an asset will be used. The Board clarified that:

a. For a nonfinancial asset, either an in-exchange or a going-concern/in-use valuation premise should be used to estimate fair value. As a basis for selecting the appropriate valuation premise, the Board decided to incorporate within the standard the concept that the fair value of the asset should reflect its highest and best use. Accordingly, an in-exchange valuation premise should be used if the highest and best use of the asset is to exchange it. A going-concern/in-use valuation premise should be used if the highest and best use of the asset is to continue to use it as currently by the reporting entity.

b. For a financial asset, an in-exchange valuation premise should be used.

The Board clarified that only those valuation techniques that are relevant/applicable and for which sufficient reliable data are available should be used to estimate fair value. In all cases, the objective is to use the valuation technique (or techniques) that best approximate the price at which an asset (or liability) could be exchanged (settled), in the circumstances.

The Board decided that the same valuation objective should apply when using bid and asked prices to estimate fair value. In that case, the Board decided to permit an estimate within the bid/asked spread that best approximates an exchange-equivalent price in the circumstances, provided that the technique used for the estimate is consistently applied. Accordingly, when using bid and asked prices in active markets to estimate fair value, the use of bid prices for assets (long positions) and asked prices for liabilities (short positions) is permitted but not required, as proposed in the proposed FVM Statement.

Objective of Meeting:

The objectives of the meeting were to resolve issues raised by respondents to the proposed FVM Statement, related to (a) valuation premise, (b) valuation techniques used to estimate fair value, and (c) the use of bid and asked prices in active markets in valuation techniques.

Matters Discussed and Decisions Reached:

Valuation Premise

1. Mr. Pinson explained that respondents raised a number of issues with respect to valuation premise. He said that in response, the staff recommends that the Board revise the related guidance to incorporate the clarifications outlined in the audience handout. Among other things, those clarifications would incorporate guidance specifying that the fair value of an asset should reflect its highest and best use.

2. Mr. Crooch said that he agrees with the highest and best use concept, but is concerned about its application in situations in which an asset that is acquired in a business combination (and measured at fair value) is not used at its highest and best use. He asked whether there would be an immediate "day 2" impairment in those situations. Mr. Trott said that would not necessarily be the case. In that regard, Mr. Trott distinguished between the impairment recognition trigger (entity-specific cash flows, undiscounted) and the impairment measurement (fair value, which would similarly consider the highest and best use of the asset).

3. Mr. Schieneman said that he is concerned that a highest and best use concept could yield inappropriate (potentially inflated) fair values. By way of example, he referred to situations in which a factory (in-use) is located on land that is valuable and has an alternative highest and best use.

4. Ms. MacDonald clarified that the measurement would consider the costs to convert the use of the asset to its highest and best use. Mr. Leisenring further clarified that the measurement would consider the likelihood of all related factors, including the economic and legal feasibility of converting the land to its highest and best use. Mr. Pinson added that a legal restriction on the highest and best use of an asset would preclude consideration of the highest and best use in the measurement.

5. Mr. Trott referred to the need to clarify aspects of the proposed guidance. In particular, he suggested that the staff (a) expand the discussion of highest and best use to more fully describe what it is and what it means to consider highest and best use in a fair value measurement, (b) clarify that selection of the valuation premise is not arbitrary but, rather, depends on the asset being measured, (c) describe the exchange unit for an asset that is used in combination with other assets in the context of a business operation rather than the enterprise, and (d) in situations in which the exchange unit measured at fair value includes multiple units of account (where the assets of the group are separately accounted for), clarify the measurement of each individual unit of account.

6. Ms. Seidman noted that for financial assets, the proposed guidance would, in effect, specify the use of an in-exchange valuation premise. She said that she agreed that an in-exchange valuation premise is the appropriate valuation premise for such assets. For nonfinancial assets, however, she suggested that the staff clarify the overall approach (in effect, outline the decision tree) for applying the proposed guidance, considering whether, as a basis for selecting the appropriate valuation premise, it would be better to focus first on the highest and best use concept. Mr. Herz agreed. He said that he viewed the proposed guidance as a set of “conceptual guidelines” and that, consistent with a goal of developing a Statement on how to measure fair value, each “guideline” should be separately illustrated by way of an example.

7. Ms. Schipper raised issues relating to the measurement of acquired in-process research and development (IPR&D) (in a business combination). In particular, she referred to situations in which a project is acquired for the purpose of withholding it from a competitor, and will not be completed ("used" in the acquired operations). She said that there is a need for more guidance in that area and suggested that the staff develop additional guidance, clarifying the highest and best use of the asset in those situations.

8. Ms. Schipper also referred to the confusion indicated by respondents in distinguishing between a going-concern/in-use valuation premise and a value-in-use measurement. She asked whether the going-concern/in-use valuation premise should refer to an asset that is configured for use. Mr. Pinson responded that while such a clarification would be generally understood for many nonfinancial assets, it might not be generally understood for intangible assets.

9. Board members generally agreed with the staff's recommendation, subject to the clarifications discussed.

Valuation Techniques

10. Ms. MacDonald explained that nearly all respondents interpreted the guidance within the proposed FVM Statement relating to the use of valuation techniques as requiring the use of multiple valuation techniques (and approaches) in all cases, which was not the Board's intent. She said that to clarify that matter, the staff recommends that a final FVM Statement (a) refer to the use of valuation techniques that are relevant and applicable in the circumstances and for which sufficient reliable data (inputs) are available (consistent with uniform standards for professional appraisal practice), thereby removing the undue cost and effort criterion and (b) emphasize that in all cases, the objective is to use the valuation technique (or techniques) that best approximate the price at which an asset (or liability) could be exchanged (settled).

11. All Board members agreed with the staff's recommendation. Ms. Schipper added that because the Statement will not specify circumstances in which a particular valuation technique will be relevant and applicable, the final Statement should clarify that judgment in applying the valuation objective, guided by valuation expertise, will be required.

Bid and Asked Prices

12. Mr. Smith explained that many respondents expressed concerns about the proposed guidance relating to the use of bid and asked prices to estimate fair value, referring to conflicts with ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies*.

13. Mr. Smith said that in view of those concerns, the staff recommends that the Board permit an estimate within the bid/asked spread that best approximates an exchange-equivalent price in the circumstances, provided that the technique used for the estimate is consistently applied. He pointed out that when using bid and asked prices in active markets to estimate fair value, the use of bid prices for assets (long positions) and asked prices for liabilities (short positions) would be permitted but not required, as proposed. He said that while the revised approach would not be convergent with the approach in IAS 39 (revised), *Financial Instruments: Recognition and Measurement*, the staff believes that the merits of the ASR 118 approach justify the lack of convergence in that regard.

14. Mr. Smith added that if the Board accepts that staff recommendation, the issue of pricing offsetting positions becomes less significant. For that reason, the staff further recommends that the Board remove the detailed guidance for offsetting positions from a final FVM Statement. Instead, to ensure that entities value offsetting positions in a manner consistent with the objective of deriving an exchange-equivalent price, the staff recommends that the Board refer to the use of consistent pricing for offsetting positions.

15. All Board members agreed with the staff's recommendations on the use of bid and asked prices to estimate fair value (in active and other markets) and with the general guidance for measurement of offsetting positions. Ms. Schipper added that the rationale for the revised guidance should be explained in the context of the valuation objective and should not imply that the resulting estimate is a free choice.

Follow-up Items:

16. With respect to the valuation premise, the Board suggested that the staff expand the proposed guidance to incorporate the clarifications discussed and develop implementation guidance illustrating the application of that guidance, focusing on the general principles that would form the basis for a "decision-tree" and IPR&D assets.

General Announcements:

None.

Board Meeting Handout
FAIR VALUE MEASUREMENT PROJECT
November 30, 2004

At the November 30, 2004 meeting, the Board will continue redeliberations of the proposed FASB Statement, *Fair Value Measurements* (FVM), considering issues raised by respondents in comment letters and at the September 21, 2004, public roundtable discussion.

1. Valuation Premise

Paragraph 13 of the proposed FVM Statement refers to the use of a valuation premise for the fair value measurements required by GAAP. In response to issues raised by respondents, the Board will discuss the need to revise the related guidance to incorporate all (or some) of the following clarifications:

a. The valuation premise provides information about the "hypothetical" exchange that forms the basis for the fair value measurement, considering whether and, if so, how marketplace participants would use an asset. A valuation premise applies for nonfinancial assets that are held and used. In contrast to financial assets, only some nonfinancial assets can be separately exchanged. For certain of those nonfinancial assets, the valuation premise can have a significant effect on the fair value measurements required by GAAP.

b. For the fair value measurements required by GAAP, either an in-exchange or a going-concern/in-use valuation premise should be used. An in-exchange valuation premise presumes that marketplace participants would not continue to use the asset as currently by the reporting entity (that is, the asset will be exchanged). A going-concern/in-use valuation premise presumes that marketplace participants would continue to use the asset (including a going-concern business) as currently by the reporting entity (marketplace participants "step into the shoes" of the reporting entity).

c. The determination of whether marketplace participants would continue to use the asset as currently by the reporting entity (as a basis for selecting the appropriate valuation premise) depends on (1) the asset and whether it provides value from its use on a stand-alone basis or together with other assets, (2) the level at which the asset would be aggregated if exchanged by marketplace participants (unit of exchange) versus the level at which the asset is aggregated by the reporting entity for financial reporting purposes (unit of account), and (3) the use of the asset that yields the highest fair value, provided that use is physically possible, appropriately justified, legally permissible, and financially feasible (highest and best use). For example:

For a nonfinancial asset that provides value principally through its use on a stand-alone basis, that is, the asset can be substituted with other equivalent assets and is separable from the other assets of the entity, the exchange transaction is presumed to occur separately, on a stand-alone/piece-meal basis. The unit of exchange is the stand-alone asset, even if the asset can be exchanged with other assets. Marketplace participants are able to separately exchange such an asset. However, whether they would actually do so depends on the highest and best use of the asset. For example, if exchanging the asset would result in a higher fair value than continuing to use the asset as currently by the reporting entity, the fair value measurement would be based on an in-exchange valuation premise. That might be the case if the asset is an office building located on land that has an alternative use and is the highest and best use for the asset. Conversely, if continuing to use the asset as currently by the reporting entity would result in a higher fair value than exchanging (selling) the asset, the fair value measurement would be based on a going-concern/in-use valuation premise. That might be the case if the asset is an office building located on land that has an alternative use but is not the highest and best use because it is not economically feasible to convert the use of the asset.

For a nonfinancial asset that provides value principally through its use together with other assets (complementary assets that, when used together, create synergies) and is not separable from the other assets of the entity, the exchange transaction is presumed to occur at the enterprise level (for example, in a business combination). The unit of exchange is the asset and its complementary assets, even if the unit of account is the stand-alone asset without its complementary assets (as might be the case for an intangible asset acquired in a business combination that arises from contractual or other legal rights and, thus, is recognized at fair value apart from goodwill). Because marketplace participants generally are not able to separately exchange such an asset, the continued use of the asset as currently by the reporting entity is presumed to be the highest and best use of the asset—its continued use having been considered in establishing the exchange value of the enterprise. The fair value measurement would be based on a going-concern/in-use valuation premise, unless the continued-use presumption is rebutted. That might be the case if the acquired business within which the asset is used will not continue as a going concern (for example, the acquired business is expected to generate future losses and, thus, will be discontinued). In that situation, an in-exchange valuation premise would be used.

d. The guidance for using a valuation premise in the FVM Statement should apply under the AICPA Practice Aid, “Assets Acquired in a Business Combination to be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries,” requiring conforming changes.

2. Valuation Techniques

The proposed FVM Statement contains several references to the use of "multiple" valuation techniques consistent with the market, income, and cost approaches to estimate fair value. Nearly all respondents interpreted that guidance as mandating the use of multiple valuation techniques consistent with the three valuation approaches, except as otherwise specified (that is, with respect to Level 1 and Level 2 estimates and with respect to the availability of information without undue cost and effort for Level 3 estimates). That was not the Board's intent. To more clearly convey its intent, the Board will consider clarifications specifying that:

a. The valuation objective is to estimate the price at which an asset (liability) could be exchanged (settled) in a current transaction (fair value).

b. An entity should use all valuation techniques (approaches) that are relevant/applicable in the circumstances, considering the availability of information (inputs) necessary to apply those techniques (approaches).

3. Bid and Asked Prices

The proposed FVM Statement does not prescribe the valuation technique (approach) that should be used to estimate fair value, except as otherwise specified in paragraph 17. Specifically, if bid and asked prices in active dealer markets are used to estimate fair value, paragraph 17 prescribes the use of bid prices for assets (long positions) and asked prices for liabilities (short positions), thereby prohibiting the method in ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies*. For offsetting positions, paragraph 17 specifies that mid-market prices should be used for the matched portion; bid and asked prices should be used for the net open position, as appropriate.

a. The Board will consider whether to retain the prescribed valuation method in paragraph 17 (for fair value estimates determined using bid and asked prices in active dealer markets) or, alternatively, whether to allow the method in ASR 118, that is, a measurement within the bid/asked spread, consistently applied (for fair value estimates determined using bid and asked prices in all markets, not just active dealer markets).

b. The Board also will consider the need for conforming changes to the detailed guidance for offsetting (risk) positions in paragraph 17. Specifically, the Board will consider whether to retain (and expand) the detailed guidance or, alternatively, whether to provide general guidance specifying that offsetting positions should be measured using a consistent price so that gains that will not be realized are not otherwise recognized merely as a result of applying a valuation method. (If offsetting positions exist in the same instrument, the same price would be used to measure both the long and short position, offsetting positions.)