MINUTES

Financial Accounting Standards Board

To: Board Members

From: Hurst (ext. 262)

Subject: Minutes of the December 17, 2003 FVM Board Meeting **Date:** December 22, 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 Hierarchy, Practicability Exceptions, and Disclosures

Basis for Discussion: Memorandum dated December 10, 2003, and Audience Handout (attached)

Length of Discussion: 1:00 p.m. to 2:20 p.m.

Attendance:

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

Summary of Decisions Reached

The Board discussed clarifications to the fair value hierarchy and other related issues, and reached the following decisions:

- The Board generally agreed that in applying the fair value hierarchy, an entity should maximize market inputs from active markets, even if the asset (or liability) being measured is not exchanged in an active market. Active markets should be distinguished from other markets based on the frequency with which assets (or liabilities) are traded without regard to liquidity. Level 1 and 2 estimates should be determined using quoted prices in active markets to which an entity has immediate access, considering the current ("as is") condition and location of the asset (or liability) being measured. In contrast, Level 3 estimates should be determined using multiple valuation techniques and a combination of market (and other) inputs. The Board clarified the "upper" and "lower" ends of Level 3 by reference to the extent to which market inputs are used in those techniques.
- The Board decided that the following information should be disclosed for recognized assets and liabilities measured at fair value: (a) the fair value amounts recognized in the statement of financial position, in total and as a percent of total assets (and liabilities), (b) how those fair value amounts were determined, that is, whether using quoted market prices for identical or similar assets (or liabilities), or other valuation techniques and, if so, the extent to which observable market inputs were used in those techniques, and (c) changes in those fair value amounts reported in earnings (or OCI) for the period.
- The Board decided to retain the practicability exceptions to fair value in existing pronouncements.

Matters Discussed and Decisions Reached

Active Markets

Mr. Pinson described the fair value measurement principle and its relationship to the fair value hierarchy. He said that the staff would like the Board to discuss certain clarifications relating to active markets, reference markets, and Level 3 valuation techniques.

Ms. Schipper asked the staff to clarify the meaning of “readily and regularly available,” as used in the description of active markets. She noted that while the New York Stock Exchange intuitively would be considered an active market with readily and regularly available quoted prices, the same might not be true for other markets with varying levels of transaction frequency. Mr. Pinson clarified that when determining what is an active market, the market for the particular security, rather than the characteristics of the market in which it is sold, should be considered. To more clearly convey that meaning of active markets, Ms. Schipper suggested that the staff avoid using terms such as “liquid,” “deep,” and “thin” to describe active markets, noting that such terms are “distractors.”

Mr. Herz noted that one of the goals of the project was to bridge the communication gap between accountants and valuation professionals and asked Mr. Pinson whether the terminology used to describe active markets (and elsewhere in the project) would be consistent with the terminology used in the valuation community. Mr. Pinson affirmed that it would not conflict with the terminology or practices used in the valuation community.

Mr. Trott referred to the issue of stale prices in active markets that has received attention in the press, especially with respect to mutual funds. He asked the Board to clarify whether it agrees that a market might be considered active even if it does not have sufficient activity to quickly absorb the sale or purchase of a large block and, if so, suggested that the Board consider the issue of stale prices (in an active market) in this project.

Mr. Herz and Ms. Seidman agreed that a market might be considered active even if it does not have sufficient activity to quickly absorb the sale or purchase of a large block, further noting that such a clarification does not conflict with their earlier decisions on block discounts. Ms. Seidman indicated that stale quotes are a distinctive characteristic of the *market* and that, as noted earlier in the discussion, the characteristics of the particular *security* should be considered when determining whether there is an active market for the security under consideration. She said that a price may not be considered stale simply because of a lack of activity in trading as long as the price is considered current. Ms. Schipper agreed, noting that the length of time will vary as to the extent a quoted price is considered to have receded for different securities, and that current valuation practice tends to consider, among other attributes, the volatility of the price in determining the necessary adjustments to the most recently quoted price.

Mr. Schieneman agreed, but emphasized the need to clearly communicate the objective of a fair value measurement so that it is not misunderstood as requiring a net realizable (liquidation) value, determined based on the amount an entity would actually realize if it were to currently sell a position. He pointed out that a fair value measurement would require a valuation determined based on an amount that might never be realized. Mr. Trott noted that such communication initiatives are an objective of this project.

Mr. Schieneman suggested that the Board eliminate Level 2. In his view, it is the "upper" level of Level 3. Mr. Pinson explained that the staff previously considered eliminating Level 2, but decided to retain it to more clearly communicate the fair value hierarchy's prioritization of quoted prices over other valuation techniques and, further, to explicitly require an assessment of the degree of subjectivity involved in adjusting a Level 2 price as a basis for determining whether that price, as adjusted, should be corroborated through the results of other valuation techniques (leading to a Level 3 estimate).

The Board generally agreed that in applying the fair value hierarchy, an entity should maximize market inputs from active markets, even if the assets (or liability) being measured is not exchanged in an active market. Active markets should be distinguished from other markets based on the frequency with which assets (or liabilities) are traded without regard to liquidity. Ms. Schipper reiterated that the references to certain potentially confusing terms should be omitted. Ms. Seidman said that the additional commentary around active markets provided by the IASB (referring to external price sources) should not be similarly included in a proposed Statement.

Reference Markets

Mr. Pinson noted the Board's previous decision that fair value estimates should be based on prices in markets to which an entity has *reasonable access*. He said that this concept could be broadly interpreted, causing entities to inappropriately "jump" markets. He noted that for similar reasons, the IASB incorporated an immediate access notion, limited to the extent of no additional cost or risk. He asked the Board for its views on whether to similarly limit that notion and, further, because it presumes the availability of prices, to incorporate that notion into Levels 1 and 2 of the fair value hierarchy.

The Board considered various situations in which entities might have access to multiple markets, referring to markets relevant to entities in the agriculture, oil and gas, and financial services (loan securitization) industries. In that regard, Board members generally agreed with an "immediate access" notion, but observed that the additional IASB limitation of no incremental cost or risk would be overly restrictive, in many cases, precluding an entity from considering the most advantageous market as a basis for a fair value estimate. Ms. MacDonald suggested removing the language the Board found restrictive and incorporating a more explicit "as is" concept instead. The Board generally agreed that in selecting the appropriate reference markets, an emphasis should be placed on the need to consider the item being measured, in particular, its current ("as is") condition and location.

The Board generally agreed that Level 1 and 2 estimates should be determined using quoted market prices in active markets to which an entity has immediate access, considering the current ("as is") condition and location of the assets (or liability) being measured. In contrast, Level 3 estimates should be determined using multiple valuation techniques and a combination of market (and other inputs). The Board also clarified the "upper" and "lower" ends of Level 3 by reference to the extent to which market inputs are used in those techniques.

Practicability Exceptions

Ms. MacDonald referred to the August 20, 2003 meeting, at which the Board asked the staff to consider the practicability exceptions to fair value in existing pronouncements within the Phase 1 scope in the context of the fair value hierarchy. She said that having done so, the staff observes that the practicability exceptions relate to "what" is being measured at fair value and raise issues beyond the scope of the project. Largely for that reason, she said that the staff recommends that the Board retain those exceptions.

Ms. Seidman said that although the issue was of concern to her, she agreed with the staff, noting that as the accounting for items affected by those exceptions is reconsidered in future projects, amendments improving or deleting those exceptions will occur naturally. She suggested, however, that the basis for conclusions refer generally to those exceptions as pertaining to Level 3 estimates.

All Board members agreed with the staff's recommendation.

Fair Value Disclosures

Ms. Hurst referred to the December 3, 2003 meeting in which the Board agreed that it should provide a fair value disclosure objective in the Statement, and asked the staff to develop disclosure requirements to meet that objective. She referred to the audience handout which outlined these requirements and referred to the sample disclosure tables included in the memorandum and asked the Board for its views on the proposed disclosure requirements.

Mr. Trott focused on the table illustrating recognized assets and liabilities measured at fair value, stating that the information reflected would be useful as they give an indication of where fair value measurements come from. He said that he found the table illustrating the change in fair value (for items with ongoing fair value measurement requirements) harder to understand because it did not clearly indicate the reasons for those changes.

Mr. Shieneman disagreed. He said that the table illustrating the change in fair value (for items with ongoing fair value measurement requirements) would provide useful information and suggested that the staff broaden that table to also include items with periodic fair value measurement requirements. In that case, the disclosure would reflect the effect on earnings of all fair value remeausurements in the period. Other Board members generally agreed with broadening that disclosure.

Mr. Herz suggested that in the table illustrating recognized assets and liabilities measured at fair value, the staff incorporate additional examples of those items with ongoing fair value measurement requirements, in particular, those that reflect ongoing Level 3 estimates, such as venture capital investments. Other Board members agreed, noting that because it was likely that the illustrative guidance would be used as a basis for developing methods for complying with the disclosure requirements, it should be as complete as possible. In that regard, Mr. Trott suggested also referring to derivatives and similar items.

Mr. Batavick referred to disclosures about the valuation techniques used to estimate fair value. He expressed concerns about the ability of entities to distinguish the extent to which observable market inputs are used in developing the estimates and, for that reason, suggested that the staff refer broadly to “quoted prices” and “other valuation techniques.” Mr. Trott suggested that the staff discuss that issue with preparers, and ascertain the extent to which such disclosures would be difficult or costly.

Mr. Crooch observed that the proposed disclosures focused both on the quantity and quality, as well as the potential accuracy of fair value information, which had been some of the main objectives of the Board in deciding whether or not to include fair value disclosure requirements in the project.

For *all* recognized assets and liabilities measured at fair value (those with ongoing and periodic fair value measurement requirements), the Board decided to require disclosures of (a) the fair value amounts recognized in the statement of financial position, in total and as a percent of total assets (and liabilities), (b) how those fair value amounts were determined, that is, whether using quoted market prices for identical or similar assets (or liabilities), or other valuation techniques and, if so, the extent to which observable market inputs were used in those techniques, and (c) changes in those fair value amounts reported in earnings (or OCI) for the period.

Next Steps

Ms. MacDonald said that at this time, the staff plans to focus on developing related implementation guidance to be included in a proposed Statement as a basis for testing the guidance discussed by the Board to date and related amendments. She asked Board members for any comments in that regard. All Board members agreed on those next steps. Mr. Herz also said that he strongly agreed with the staff's view discussed in the memorandum that FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, should remain unchanged until such time as the Board addresses related conceptual issues.

Follow-up Items

None.

General Announcements

None.

BOARD MEETING HANDOUT
FAIR VALUE MEASUREMENT PROJECT

At its December 17, 2003 meeting, the Board will discuss clarifications to the fair value hierarchy and other related issues.

1. THE FAIR VALUE HIERARCHY

The fair value measurement principle refers to fair value estimates determined based on the results of valuation techniques that maximize market inputs. The fair value hierarchy prioritizes those techniques, considering the relative reliability of the resulting estimates. The Board will discuss clarifications focusing on the market inputs used in those techniques.

a. Active versus Other Markets

To provide a benchmark with which to assess relevant market inputs, the Board will discuss whether to include in the Fair Value Statement a general description of active markets referring to liquid markets in which quoted prices that represent actual market transactions are readily and regularly available from external sources (similar to IAS 39), further clarifying that the determination of whether such markets are active does *not* depend on whether they can rapidly absorb the quantity held by the entity without significantly affecting the price.

Related clarifications to the fair value hierarchy would include the following:

- Levels 1 and 2 would refer to valuation techniques that use quoted prices for identical or similar items in *active* markets as a primary market input

- Level 3 would refer to the use of *multiple* valuation techniques, defining the "upper" and "lower" ends of its spectrum by reference to the extent to which market inputs are used in developing the estimate.

b. Reference Markets

Previously, in the context of reference markets, the Board generally agreed that a fair value estimate should be based on the price in the market to which an entity has *reasonable access* or, if the entity has access to more than one market, the most advantageous price—even if the entity does not intend to access that market. The Board will discuss whether to modify that guidance, referring instead to the price in the market to which an entity has *immediate access without additional cost or risk* (similar to IAS 39), further clarifying Levels 1 and 2 of the fair value hierarchy accordingly.

2. PRACTICABILITY EXCEPTIONS

The Board will discuss whether to eliminate any of the practicability exceptions to fair value measurements in existing pronouncements within the Phase 1 scope. Those exceptions relate principally to financial instruments addressed in FAS 107, FAS 115, FAS 124, and FAS 140.

3. FAIR VALUE DISCLOSURES

The Board will continue its discussion of fair value disclosures from its December 3, 2003 meeting, focusing on recognized assets and liabilities measured at fair value in the statement of financial position. Specifically:

- For each major class of assets (and liabilities) with ongoing fair value measurements (for example, trading securities) and for assets (and liabilities) with periodic fair value measurements (for example, impaired long-lived assets), the Board will discuss whether to require disclosure of (a) the fair value amounts, in total and as a percent of total assets (and liabilities), and (b) the valuation techniques used to determine those fair value amounts (whether using quoted market prices or other valuation techniques and the extent to which market inputs are used in those valuation techniques).

- For each major class of assets (and liabilities) with ongoing fair value measurements (for example, trading securities), the Board will discuss whether to also require disclosure of the effect of changes in the fair value measurements on earnings for the period.