MINUTES

To:	Board Members
From:	FVM Team (Murphy x208)
Subject:	Minutes of the June 29, 2005 FVM Board Meeting—Definition, Transaction Price Presumption, and Hierarchy
Date:	July 7, 2005
cc:	Bielstein, L. Smith, Petrone, Fair Value Team, Revenue Recognition Team, Business Combinations Team, Polley, Gabriele, Getz, Carney, Mahoney, Sutay, Leisenring (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:	Proposed FASB Statement, *Fair Value Measurements*: definition, transaction price presumption, and hierarchy
Basis for Discussion:	Memorandum dated June 16, 2005, and audience handout (attached)
Length of Discussion:	9:00 a.m. to 10:00 a.m.

Attendance:

Board members present:	FASB: Batavick, Crooch, Herz, Schipper, Seidman, Trott, and Young
Board members absent:	None
Staff in charge of topic:	MacDonald
Other staff at Board table:	Belcher, Johnson, McBride, Murphy, E. Smith, L. Smith, and Todorova
Outside participants:	None

Summary of Decisions Reached

The Board clarified aspects of the definition of fair value and the related guidance for applying that definition included in the proposed FASB Statement, *Fair Value Measurements* (FVM).

The Board revised the definition of fair value to refer to an estimate of the price that could be received for an asset or paid to settle a liability in a current transaction between marketplace participants in the reference market for the asset or liability.

In its earlier discussions, the Board clarified that the reference market is the most advantageous market for the asset or liability considered from the perspective of the reporting entity. The Board further clarified that at initial recognition, the transaction price might not provide presumptive evidence of the fair value of an asset or liability if the market in which the transaction occurs is not the most advantageous market for the asset or liability considered from the perspective of the entity.

The Board expanded the levels within the fair value hierarchy to segregate quoted prices for identical assets or liabilities in active markets (Level 1), quoted prices for similar assets or liabilities (Level 2), direct market inputs other than quoted prices (Level 3), indirect market inputs (Level 4), and entity inputs (Level 5). The five-level hierarchy should be used to estimate fair value. A three-level hierarchy should be used for related disclosures to segregate those estimates that fall within Level 1, Levels 2 and 3, and Levels 4 and 5.

Objective of Meeting

The purpose of the meeting was to clarify aspects of the fair value guidance discussed to date.

Matters Discussed and Decisions Reached

Fair Value Definition

1. Ms. MacDonald said that the staff recommends that the Board revise the current definition of fair value to refer to "an estimate of the price that could be received for an asset or paid to settle a liability in a current transaction between marketplace participants in the reference market for the asset or liability." The staff believes those revisions are needed to more clearly convey the following:

a. The exit price objective encompassed within the most advantageous reference market principle, which refers to the price that maximizes the amount that could be received for an asset (future inflows) or minimizes the amount that could be paid to settle a liability (future outflows)

b. The emphasis on marketplace participants—the "unrelated willing parties" in the current definition

c. That the price that forms the basis for a fair value measurement at the specified measurement date is an estimate until such time as an actual transaction for the asset or liability occurs, whether that price is observed within Level 1 of the fair value hierarchy or otherwise derived.

2. Ms. MacDonald further clarified that in all cases the reference market for the asset or liability would be considered from the perspective of the entity. However, as previously discussed by the Board, the price in that market would be used for the estimate without regard to the entity's intent and (or) ability to currently transact in that market. In that regard, the emphasis is on marketplace participants.

3. All Board members agreed with the staff recommendation, subject to clarification.

4. Mr. Herz suggested that the FVM Statement include clarifying guidance focusing on those key aspects of the definition.

5. Ms. Seidman expressed concerns about an explicit statement to the effect that the price that forms the basis for the estimate is the price in the most advantageous (reference) market "without regard to whether the entity has the ability to access the market." She said that the FVM Statement should remain silent in that regard.

6. Ms. Schipper said that the clarifying guidance should make it clear that a fair value estimate is possible even if the estimate is derived using a hypothetical market construct. She emphasized that in the absence of an observable transaction or market for the asset or liability, the question is not whether it can be measured using a fair value measurement attribute. Rather, the question is whether it is feasible, practicable, and cost beneficial to do so.

Transaction Price Presumption

7. Ms. MacDonald explained that in the Board's redeliberations of the FVM Statement, it affirmed that in an actual transaction involving the entity, the price paid for an asset or received for a liability is presumed to represent the fair value of the asset or liability at initial recognition, absent persuasive evidence to the contrary. She said that the staff observes that from the perspective of the entity, the transaction price is an entry price (the price paid for an asset or received for a liability) and that the entry price will be different from the exit price that forms the basis for the estimate where the market in which the transaction occurs is not the most advantageous reference market for the asset or liability (the market with the price that maximizes the amount that could be received for the asset or paid to settle the liability). In those cases, the staff believes that the transaction price presumption would be rebutted by an entity's estimate of the price in the most advantageous market for the asset or liability, regardless of where within the fair value hierarchy the estimate falls. Ms. MacDonald said that the staff recommends that the Board revise the related guidance in the FVM Statement accordingly.

8. Ms. Schipper and Mssrs. Crooch and Trott generally agreed with the staff recommendation.

9. Ms. Schipper emphasized that in considering this issue, she focused on the need to identify what is being measured (unit of account) from the perspective of the entity. She said that at the inception of a commercial transaction, what is being measured is everything that remains unperformed (or uncollected), that is, the remaining asset or liability. The transaction price measures the fair value of the transaction in the aggregate and does not

distinguish between what has or has not yet been performed (or collected). In contrast, an entity's estimate based on a price in the most advantageous market for the remaining asset or liability measures the fair value of that remaining asset or liability, that is, the unperformed (or uncollected) element encompassed in the transaction. She said that while the counterparty (buyer) likely will only have access to the retail market in which the transaction occurs, the entity (seller) likely will have access to an alternative more advantageous market for the asset or liability (for example, a dealer-to-dealer market). She said that the price in the most advantageous market for the asset or liability should be used for the estimate, whether it is observable or otherwise derived using market and (or) entity inputs.

10. Ms. Schipper said that conceptually, a difference between the transaction price and the entity's estimate represents what has been performed (or collected) at contract inception (in effect, selling efforts). She clarified that the transaction price presumption approaches the measurement from the standpoint that at contract inception, the entity has not yet done anything (selling efforts). Therefore, where there is a difference between the transaction price and the entity's estimate, the entity must demonstrate that it has done something. In other words, the burden of proof is on the entity. She acknowledged that as a practical matter, however, all (or some) of that difference could represent measurement error. In response, the Board could provide special recognition guidance for that difference specific to such arrangements (in other pronouncements).

11. Mr. Trott referred to the need to consider the transaction price presumption and the related reference market principle separately, from the perspective of both the counterparty (buyer) and the entity (seller). He said that from the perspective of the counterparty (buyer), the transaction price presumption generally would not be rebutted because the counterparty (buyer) likely will only have access to the retail market in which the transaction occurs. From the perspective of the entity (seller), however, the transaction price generally would be rebutted because the entity (seller) likely will have access to

alternative more advantageous markets. Mr. Trott said that distinction is important in the Board's revenue recognition project, where the revised measurement approach is from the perspective of the counterparty (buyer) rather than the entity (seller) and, thus, looks to the transaction price as the initial measure of the performance obligation(s).

12. Ms. Seidman and Mssrs. Batavick, Herz, and Young initially disagreed with the staff recommendation. They said that in order to rebut the transaction price presumption, the estimate should be derived principally by market inputs in an observable reference market. In the absence of market inputs, the transaction price provides the best estimate of fair value.

13. Mr. Herz said that in order to rebut the transaction price presumption, an actual reference market for the asset or liability must exist; it cannot simply be hypothesized. Further, there must be persuasive evidence within that market that meets a minimum reliability threshold.

14. Ms. Seidman said that she views this issue as an application of the fair value hierarchy. For example, one must assume that a transaction with a customized long-term derivative is an at-the-money transaction. In the absence of market inputs within the fair value hierarchy, the transaction price provides the best evidence of fair value of that transaction at inception. Applying the fair value hierarchy for the purpose of rebutting the transaction price presumption isolates the difference between the transaction price and a model value as measurement error. An entity should not rebut the transaction price presumption when it cannot be sure how much of the difference relates to measurement error.

15. Ms. Seidman further observed that in the context of the staff recommendation, the transaction price presumption would be redundant to the counterparty (buyer) and nonsubstantive to the entity (seller).

16. The Board considered the application of the transaction price presumption more specifically in the context of the derivative transactions addressed in 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." In that context, all Board members generally agreed that where the market in which a transaction occurs is not the most advantageous market for the asset or liability, the transaction price presumption might be rebutted by an entity's estimate of the price (layoff amount) in that market at initial recognition (contract inception). In considering whether the transaction price presumption is rebutted, the emphasis is on the *remaining* assets and liabilities being measured (unit of account) and the most advantageous market for those assets and liabilities (versus the transactions in which those assets and liabilities arise), as previously clarified by Ms. Schipper. The emphasis is not on the extent to which the entity's estimate is supported by market inputs, as previously discussed by the Board.

Fair Value Hierarchy

17. Ms. MacDonald said that the final issue for the Board's consideration relates to the fair value hierarchy; specifically, the inputs encompassed within the hierarchy and the grouping of those inputs for both measurement and disclosure purposes. She referred to the revised fair value hierarchy proposed by the staff included on the audience handout (attached), noting the following:

a. Level 1 would not change (it would segregate PxQ estimates).

b. Level 2 would refer to quoted prices for similar assets or liabilities in all markets, adjusted as appropriate for differences. Also, consistent with earlier discussions, related guidance would clarify that adjustments within Level 2 should be supported by other market inputs and that more subjective adjustments would render the estimate a lower level estimate.

c. Level 3 would refer to direct market inputs that are observable over the full term of the asset or liability.

d. Level 4 would refer to indirect market inputs that are observable over the full term of the asset or liability.

e. Level 5 would isolate the entity inputs that are used as a practical expedient in the absence of market inputs.

18. Ms. MacDonald said that the staff recommends that the FVM Statement set out that 5-level hierarchy for measurement purposes and a 3-level hierarchy for disclosure purposes, segregating Level 1, Levels 2 and 3, and Levels 4 and 5.

19. All Board members agreed with the staff recommendation, subject to clarification.

20. Ms. Schipper suggested revisions to clarify that within Levels 4 and 5, the correlation is what creates the corroboration. Ms. Schipper further observed that within Level 5, some entity-specific estimates are subject to verification difficulties (such as those that involve a forecast or extrapolation). In contrast, other entity-specific estimates are easily verifiable but not representationally faithful (such as an entity's internal cost data from its own records). She observed that persons in practice are sometimes more concerned about verifiability than they are about representational faithfulness. In response, she suggested that the Board consider the need to clarify through the FVM Statement the interaction of verifiability and representational faithfulness within Levels 4 and 5 (in the form of implementation guidance or a discussion in the basis for conclusions).

21. Mr. Herz said that in the revised fair value hierarchy, some estimates within Level 3 (inputs in active markets) could potentially be better (more reliable) than those within the broadened Level 2 (quoted prices in inactive or thin markets). Ms. Schipper agreed. She suggested that in drafting the FVM Statement, the staff clarify that the fair value hierarchy allows judgment in assessing the quality of the inputs generally and not preclude the use of a highly verifiable measurement technique that uses inputs other than quoted prices in inactive (thin) markets for fair value estimates. She further suggested that the staff balance the related application guidance, separately focusing on financial instruments and on intangible assets (in-process research and development that is acquired as part of a business combination).

<u>Follow-up Items:</u>

22. None.

<u>General Announcements:</u>

23. None.

Financial Accounting Standards Board

Board Meeting Handout

ATTACHMENT

FAIR VALUE MEASUREMENT PROJECT
June 29, 2005 Board Meeting

The Board will clarify aspects of the guidance that would be included in a final FASB Statement, *Fair Value Measurements* (FVM Statement).

1. FAIR VALUE DEFINITION

The FVM ED defines fair value as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties."

In its redeliberations, the Board clarified the exchange price notion included in the definition in the context of an exit price in the reference market for the asset or liability. Consistent with an exit price objective, the reference market is the market with the price that maximizes the amount that would be received for an asset or minimizes the amount that would be paid to settle a liability, in other words, the most advantageous market for the asset or liability.[1] The reference market is considered from the perspective of the entity. However, the price in that market is used regardless of an entity's intent or ability to currently access that market (except as otherwise specified for Level 1 estimates). In other words, the emphasis is on marketplace participants.

To more clearly convey the exit price objective that forms the basis for the definition, the Board will consider whether to clarify the definition, thereby defining fair value as "an estimate of the price that could be received for an asset or paid to settle a liability in a current transaction between marketplace participants that are both able and willing to transact in the reference market for the asset or liability."

2. TRANSACTION PRICE PRESUMPTION

In its redeliberations, the Board affirmed that in an actual transaction involving the entity, the price paid for an asset or received for a liability is presumed to represent the fair value of the asset or liability at initial recognition, absent persuasive evidence to the contrary. The Board will consider whether persuasive evidence rebutting the presumption exists if the market in which the transaction occurs is not the reference market for the asset or liability, thereby distinguishing between a transaction price (an entry price) and the exit price that forms the basis for the estimate.

[1] Where there is a principal market for the asset or liability, that market is presumed to represent the most advantageous market for the asset or liability. In the absence of a principal market, the reference market is the most advantageous market for the asset or liability.

3. FAIR VALUE HIERARCHY

The Board will consider clarifications to the fair value hierarchy to more clearly convey the inputs that should be used to estimate fair value:

Level 1—Quoted prices for identical asset or liabilities in active markets.

Level 2—Quoted prices for similar assets or liabilities, adjusted as appropriate for differences between the asset or liability and the similar assets or liabilities.

Level 3—Market inputs that relate directly to the asset or liability and are observable over the full term of the asset or liability (direct market inputs). Those inputs include information about interest rates, yield curves, volatilities, prepayment speeds, default rates, loss severities, credit risks, liquidities, foreign exchange rates, and other relevant statistics, including a current published index.

Level 4—Market inputs that relate indirectly to the asset or liability, including correlated, interpolated, or extrapolated measures that are corroborated by direct market inputs.

Level 5—Entity inputs, including correlated, interpolated, or extrapolated measures that are not corroborated by direct market inputs.