

Technical Line

FASB – final guidance

Fair value measurement

A closer look at the converged guidance

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What you need to know

- ▶ Common requirements now exist for determining fair value and the related disclosures under US GAAP and IFRS.
- ▶ While many principles under US GAAP remain the same, the amendments' effects will likely vary by company and they could be significant.
- ▶ The new disclosure requirements could present operational challenges for many companies.
- ▶ The amendments to US GAAP become effective in 2012.

Overview

With ASU 2011-04 and IFRS 13¹, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) (collectively, the Boards) have generally created a uniform framework for applying fair value measurement principles for companies around the world. These standards represent converged guidance that the Boards believe will reduce complexity in applying the principles of fair value and improve consistency in financial reporting across jurisdictions.

From a US GAAP perspective, the FASB's primary reason for issuing the ASU was convergence. As a result, many of the amendments to ASC 820² clarify existing concepts and are generally not expected to result in significant changes to how many companies currently apply the fair value principles. Many of the amendments eliminate wording differences or try to make the converged guidance more understandable for companies applying it under IFRS for the first time.

In certain instances, however, the FASB changed a principle to achieve convergence. While limited, these amendments have the potential to significantly change practice for some companies. For example, the amendment to prohibit the

use of block discounts in all fair value measurements will likely affect a number of companies (particularly financial institutions).

This publication is written from a US GAAP perspective and provides our thoughts on the key amendments and clarifications made to ASC 820, including the new disclosure requirements. It does not address potential changes in practice under IFRS that could result from the adoption of IFRS 13. Practice continues to evolve and readers should continue to monitor developments in this area.

Appendix A summarizes the amendments to ASC 820. Appendix B includes questions and interpretive responses on several implementation issues related to the ASU.

Background

The FASB issued comprehensive guidance³ in 2006 on how to measure fair value when required or permitted by other standards. Guidance on how to measure fair value in IFRS has been limited to provisions in multiple standards that sometimes presented conflicting concepts. In 2009, the IASB issued an Exposure Draft, *Fair Value Measurement* (the IASB ED), with the aim of creating a fair value framework to be used consistently in IFRS.

The IASB ED was largely consistent with ASC 820, but certain elements differed from US GAAP. When commenting on the IASB ED, many constituents stressed the importance of converged guidance. In response, the Boards agreed to deliberate jointly, with the objective of eliminating all substantive differences between the IASB ED and ASC 820. This objective was effectively met, although certain limited differences remain. Those differences are discussed later in this publication.

There are also differences between US GAAP and IFRS about *what* is measured at fair value, but those differences are outside the scope of the joint project, which focused on *how* to measure fair value.

Summary of the amendments

The amendments to ASC 820 generally fall into the following three categories:

- ▶ Changes to a principle or requirement for measuring fair value
- ▶ Clarifications of the FASB's intent regarding the application of existing requirements
- ▶ Additional disclosure requirements

Key amendments in each of these categories are discussed in detail below.

Changes to existing principles

Measurement of financial instruments

During their deliberations, the Boards noted that financial instruments do not have alternative uses and that their fair values usually do not depend on their use within a group of other assets or liabilities. The ASU therefore specifies that the concepts of "highest and best use" and "valuation premise" are relevant only when measuring the fair value of nonfinancial assets.

The result is that fair value for financial instruments should be largely based on the unit of account prescribed by the Topic that requires (or permits) the fair value measurement. This is often deemed to be the individual financial instrument. For example, the unit of account in ASC 815⁴ for derivative instruments is generally deemed to be the individual contract because that is the level at which hedge effectiveness is assessed.

The fair value framework, as modified by the ASU, would therefore have required all derivative contracts to be measured on an individual basis, consistent with their unit of account. That would have caused a significant change from current practice, as valuation adjustments related to over-the-counter (OTC) derivative contracts are typically determined on a portfolio basis. Constituents argued that calculating valuation adjustments for market and credit risk on a gross basis would be inconsistent with their risk management practices and that the sum of the fair values of the individual instruments is not equal to the fair value of their net risk exposure.

To maintain current practice, the ASU provides an exception that allows a company to measure the fair value of a group of financial assets and liabilities with offsetting risks based on the sale or transfer of its net exposure to a particular risk (or risks), if certain criteria are met. The Boards acknowledge that this measurement approach is an exception to the principles of fair value because it represents an entity-specific measure (i.e., a company's net risk exposure is a function of the other financial instruments specifically held by that company and its unique risk preferences).

How we see it

In general, we believe the measurement exception will allow companies to continue current practice when determining derivative valuation adjustments for bid-ask spreads and credit risk on a net basis. However, companies should ensure they comply with the specified criteria discussed next.

Application of the measurement exception

Companies that hold a group of financial assets and liabilities are generally exposed to market risks (e.g., interest rate risk, currency risk, etc.) and to the credit risk of each of its counterparties. The ASU allows companies to make an accounting policy election to measure the fair value of a group of financial assets and liabilities based on the price that would be received to sell a net long position or transfer a net short position for a particular risk exposure if all of the following criteria are met:

- ▶ The company manages the group of financial assets and liabilities on the basis of its net exposure to a particular market risk or to the credit risk of a particular counterparty in accordance with its documented risk management or investment strategy.
- ▶ The company provides information about the group of financial instruments to key management on this basis.
- ▶ The company measures all of the financial assets and liabilities in the group at fair value in the statement of financial position each reporting period.

The ASU includes specific considerations for applying the measurement exception to net exposures related to both market and credit risks.

Additional considerations for offsetting market risks

When using the exception to measure a company's net exposure to a particular market risk, the ASU requires that the offsetting market risks be "substantially the same." For example, companies would not be able to offset the interest rate risk associated with a financial asset with the currency price risk associated with a financial liability because these two market risks are not substantially the same. The combination of these financial instruments does not mitigate the market risk for either the financial assets or liabilities.

We believe a company exposed to different forms of offsetting interest rate risk (for example, a long exposure to USD LIBOR that is partially offset by a short exposure to the USD prime rate) would generally meet the "substantially the same" threshold. Although some basis risk exists between the positions, the combination of these financial instruments mitigates the company's overall interest rate risk. While the measurement exception could be used in this instance, the fair value measurement of the net long position should incorporate this basis risk.

Similarly, the ASU requires that the duration of a company's exposure to a certain market risk arising from a group of financial assets and liabilities be substantially the same. For example, a company that holds a financial asset with a three-year maturity and a financial liability (whose risk is substantially the same as the financial asset) with a one-year maturity would measure the one-year exposure on a net basis, but the remaining two-year exposure on a gross basis.

Additional considerations for offsetting credit risks

To measure its counterparty credit risk on a net basis, a company must have an arrangement in place that mitigates credit risk upon default (such as a master netting agreement or a collateral exchange agreement with the counterparty) that market participants would take into account when pricing the exposure.

It is important to note that a company is not required to prove that such agreements will be "legally enforceable" in all jurisdictions to use the measurement exception. Instead, a company should consider market participant expectations about the likelihood that such arrangements would be legally enforceable when valuing the net credit exposure.

Other application issues

To use the measurement exception, companies are required to meet all the criteria noted above both initially and on an ongoing basis. While the Boards indicated that a company may change its election if its risk exposure preferences change, we generally expect companies to use the exception consistently given that they generally do not change their risk management policies from period to period.

As the general criteria above indicate, the measurement exception applies only to financial instruments with offsetting risks. A group of financial instruments comprised of only financial assets (such as a portfolio of loans) would not qualify for the exception and would need to be valued in a manner consistent with its unit of account. (Refer to the discussion of valuation inputs to be considered in the "Other premiums and discounts" section later in this publication.) The ASU also indicates that the measurement exception can be applied only to financial assets and liabilities that are within the scope of ASC 815 or ASC 825.⁵

The measurement exception applies only to financial instruments with offsetting risks.

A company can elect the measurement exception on a portfolio-by-portfolio basis. In addition, companies are not required to apply the exception to all of the risks related to the financial assets and liabilities that make up a particular group. As such, a company could choose to measure only the credit risk associated with a group of financial instruments on a net basis, but not the group's market risks.

A company also may apply the exception to only certain market risks related to the group. For example, a company that is exposed to both interest rate and foreign currency risk in a portfolio of financial assets and liabilities could choose to measure only its interest rate risk exposure on a net basis.

The measurement exception also allows the current practice of offsetting credit and market risks at different levels of aggregation to continue. In their respective Basis for Conclusions, the Boards acknowledge that this approach may be required because it is unlikely that all of the financial assets and liabilities giving rise to the net exposure for a particular market risk will be with the same counterparty. The example below illustrates this concept.

Illustration 1 – Calculating net exposure

Company XYZ holds a portfolio of long and short derivative positions (USD interest rate swaps and USD/JPY foreign currency forwards) with various counterparties as follows:

- ▶ Counterparties A, B and C: only interest rate swaps
- ▶ Counterparty D: interest rate swaps and foreign currency forwards
- ▶ Counterparties E, F and G: only foreign currency forwards

Company XYZ has executed master netting agreements with each of its counterparties except counterparty G. In addition, the agreement in place with counterparty D can be applied across products.

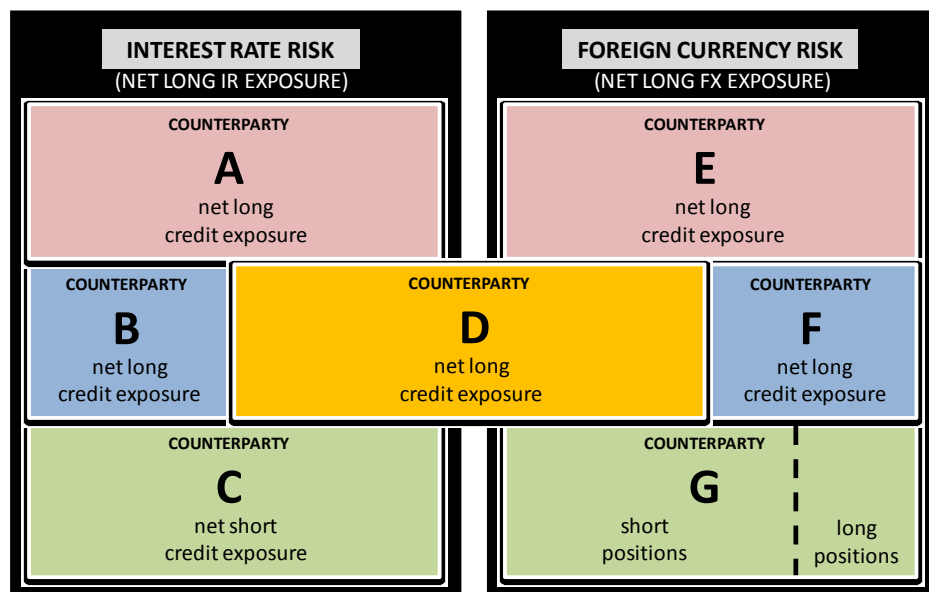


Illustration 1 – Calculating net exposure (continued)

Using the measurement exception provided in the ASU, Company XYZ may consider its credit risk exposure to each individual counterparty except counterparty G on a net basis (i.e., net long credit exposure to Counterparty A, net short credit exposure to Counterparty C, etc.).

At the same time, the company may consider its net long exposure to USD interest rate risk from its portfolio of interest rate swaps with counterparties A, B, C and D. The company may also consider its net long exposure to foreign currency risk (Japanese yen risk) from its portfolio of foreign currency derivatives with counterparties D, E, F and G.

Presentation considerations

The exception in the ASU applies only to the measurement of financial instruments. The guidance clarifies that this exception to measure financial instruments on a net basis does not affect financial statement presentation. That is, companies are required to comply with the financial statement presentation requirements specified in other Topics. (In a separate project, the Boards are considering whether companies should be able to offset financial assets and liabilities on their balance sheets.)

Companies may need to allocate portfolio-level adjustments for disclosure purposes when items in the group fall into different levels of the fair value hierarchy. (Refer to FAQ 20-12 in EY's Financial Reporting Developments publication on fair value for additional discussion on portfolio-level adjustments.)

Block discounts

The ASU describes a block discount (or blockage factor) as an adjustment to the quoted price of an asset or liability because the market's normal trading volume for the item is not sufficient to absorb the quantity of the instrument held by the reporting entity. The ASU clarifies that a premium or discount that reflects size as a characteristic of a company's holding, such as a block discount, should not be included in any fair value measurement. Put another way, the ASU extends ASC 820's current prohibition on block discounts for Level 1 measurements to all fair value measurements, regardless of hierarchy level.

The Boards decided to prohibit block discounts because they believe that such an adjustment is specific to the size of a company's holding and its decision to transact in a block, not a characteristic of the asset or liability itself.

How we see it

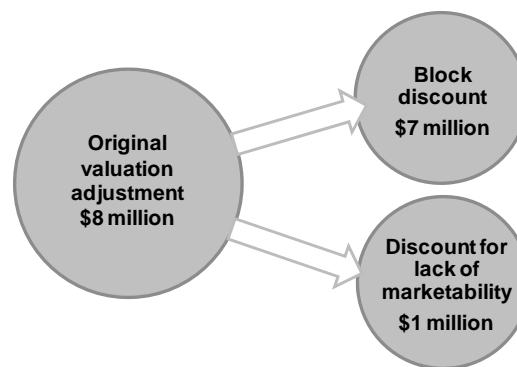
The prohibition on block discounts for all fair value measurements will result in a change in practice for companies that apply valuation adjustments based on the size of the position they hold in a Level 2 or Level 3 instrument.

Premiums or discounts that reflect the size of a company's holding – and not of the asset or liability being measured – are prohibited.

Illustration 2 highlights how practice may change based on the prohibition of block discounts.

Illustration 2 – Block discounts

- ▶ Bank X has a large holding in a bond issue that does not trade in an active market and thus is not classified in Level 1.
- ▶ The fair value is based on quoted prices for similar bonds that trade more frequently, with appropriate adjustments for differences between these bonds and the item being measured.
- ▶ Under current guidance in ASC 820, the fair value of Bank X's bond position is estimated to be \$100 million, which incorporates an \$8 million valuation adjustment for "liquidity."
- ▶ This adjustment historically considered both the size of Bank X's holding relative to market activity as well as the marketability of the instrument itself (as shown below).



All else being equal, upon the adoption of the ASU, the fair value of Bank X's bond position would be \$107 million (instead of \$100 million). Bank X would not be able to recognize the \$7 million block discount because this adjustment is deemed to be a characteristic that is specific to Bank X (i.e., the size of Bank X's holding). However, a discount for lack of marketability would still be acceptable if this adjustment reflected a characteristic of the bond itself (i.e., if market participants would require a similar adjustment in a transaction for an individual bond).

Other clarifications

Other premiums and discounts

The ASU indicates that companies should select inputs that are consistent with the characteristics of an asset or liability that market participants would consider in a transaction for that asset or liability. In certain instances, these characteristics could result in the application of an adjustment, such as a premium or discount.

The ASU did not amend the principle in ASC 820 that instruments that trade in active markets should generally not be adjusted from a Level 1 value based on the quoted price of the individual instrument multiplied by the number of shares held (i.e., $P \times Q$). However, the ASU is less prescriptive about when premiums and discounts (other than block discounts) may be applied.

Premiums and discounts (such as control premiums or discounts for lack of marketability) may be incorporated into a non-Level 1 fair value measurement if all of the following conditions are met:

- ▶ The application of a premium or discount reflects the characteristics of the asset or liability being measured.
- ▶ Market participants, acting in their “economic best interest,” would consider these premiums and discounts when pricing the asset or liability.
- ▶ The inclusion of a premium or discount is not inconsistent with the unit of account in the Topic that requires or permits the fair value measurement.

Unlike block discounts, which are deemed to be entity-specific, adjustments reflecting size as a characteristic of the asset or liability being measured may be incorporated into a fair value measurement, depending on the facts and circumstances. For example, a control premium in valuing a controlling equity interest in a private company (see Illustration 3) or a marketability discount in valuing an individual financial instrument that has a large notional amount when compared to the market norm (see Illustration 4) may be considered in certain cases when measuring fair value.

Illustration 3 – Control premiums

An investment company (e.g., a private equity fund) acquires a controlling interest in a private company. When measuring the fair value of its equity interest in this portfolio company, the investment company would generally not be precluded from considering a control premium based on the following considerations:

- ▶ The equity investment represents a controlling interest.
- ▶ The shares of the portfolio company are not traded on an active market (i.e., not a Level 1 measurement).
- ▶ Market participants acting in their economic best interest would likely consider such a premium when valuing the controlling interest.
- ▶ The inclusion of a control premium would not be inconsistent with the unit of account guidance in ASC 946.⁶

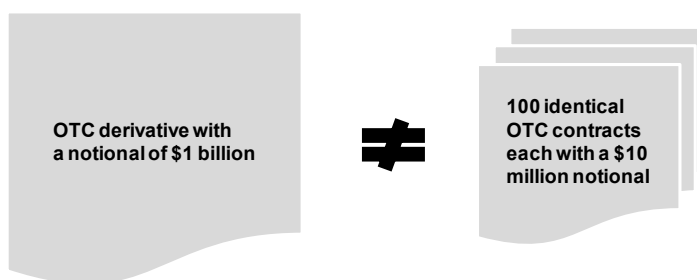
Had the portfolio company’s shares been, and continued to be, publicly traded (i.e., a Level 1 measurement), the investment company could not incorporate a control premium in measuring fair value, consistent with existing practice.

Refer to Question 2 of Appendix B on how the ASU would apply when an investment company holds both debt and a controlling equity interest in the same portfolio company.

Illustration 4 – Marketability discount

- ▶ Bank X has one outstanding OTC derivative contract with Dealer A.
- ▶ The notional amount of this contract is \$1 billion, which is significantly larger than the market norm for these types of contracts.
- ▶ Bank Y has 100 identical OTC derivative contracts outstanding with various dealers (whose risks are not offsetting because all the contracts are assets).
- ▶ Each of the 100 contracts has a notional amount of \$10 million, which is consistent with the market norm for these types of contracts.

Although Bank X and Bank Y have virtually identical market exposures (ignoring credit risk for simplicity), the ASU would allow Bank X to consider a discount for lack of marketability but would preclude Bank Y from applying a similar discount.



For Bank X, the large notional amount (\$1 billion) is a characteristic of the instrument that would likely be considered by market participants when transacting for the derivative based on its unit of account.

In contrast, the unit of account for Bank Y's 100 derivative contracts is the individual OTC contract (and not the block). As a result, a discount that is applied by Bank Y based solely on the size of its holding (i.e., 100 contracts) would be considered a block discount that cannot be considered in the fair value measurement.

With a few exceptions, the requirements for measuring the fair value of own equity instruments are identical to the guidance for liabilities.

Measurement of liabilities and own equity instruments

Liabilities

The FASB originally addressed questions surrounding how to determine the fair value of a liability in ASU 2009-05.⁷ That guidance indicated that using the quoted price for an identical (or similar) liability when traded as an asset is an appropriate way to estimate the fair value of a liability. Companies questioned whether this approach should be applied when the corresponding asset held by another party did not trade.

To eliminate diversity in practice, the ASU clarifies that when the quoted price for the transfer of an identical (or similar) liability is not available and the identical item is held by another party as an asset, a company should measure the fair value of the liability from the perspective of a market participant that holds the instrument as an asset. This amendment clarifies that the use of a corresponding asset to measure a liability is not limited to instances when the corresponding asset trades. (Refer to Question 3 in Appendix B for how the ASU applies when determining the fair value of contingent consideration liabilities.)

The ASU also clarifies how to measure the fair value of a liability when the identical instrument is not held by another party as an asset (e.g., an asset retirement obligation). In these instances, it is likely that a present value technique will be needed to estimate the future cash outflows that market participants would expect to incur in fulfilling the obligation. These future outflows should capture market participant expectations related to both the costs to fulfill the obligation and the compensation required for taking on the obligation. The ASU indicates that the compensation market participants would require consists of two components:

- ▶ Compensation for undertaking the activities required to fulfill the obligation (i.e., for using resources that could have been allocated for other activities)
- ▶ A risk premium reflecting the risk that actual cash outflows may differ from the expected cash outflows

Own equity instruments

Although ASC 820 currently applies to instruments classified in stockholders' equity, it does not provide explicit guidance for measuring the fair value of these types of instruments. The ASU clarifies that companies should measure the fair value of their equity instruments consistent with the guidance for measuring liabilities (i.e., from the perspective of a market participant who holds the identical equity instrument as an asset, when applicable).

Principal market

The ASU reaffirms the requirement in ASC 820 that a fair value measurement assumes the asset is sold or the liability is transferred in the principal market. The Boards clarified that the principal market for an asset or liability should be determined based on the market with the greatest volume and level of activity that the company can access, not the company's own level of activity in a specific market. (Refer to Chapter 7 of EY's Financial Reporting Developments publication on fair value for additional discussion and examples illustrating this concept.)

However, the ASU also includes a rebuttable presumption that the market in which a company normally transacts for the asset or liability is the principal market, unless contrary evidence exists. The ASU indicates a company is not required to undertake an exhaustive search of all possible exit markets for the asset or liability, but cannot ignore information that is reasonably available in assessing which market has the greatest volume and level of activity. A company would look to the most advantageous market to measure an asset or liability only in the absence of a principal market. (In practice, the principal and most advantageous markets are often the same.)

Market participants

ASC 820 currently describes market participants as being independent of the reporting entity. The ASU amends this guidance to indicate that market participants are assumed to be independent of each other. This clarification emphasizes that a fair value measurement assumes an orderly transaction between market participants at the measurement date, not an orderly transaction between the reporting entity and another market participant.

Although this amendment makes clear that market participants are not related parties, the ASU indicates that the price in a related party transaction may be used as an input in a fair value measurement if a company has evidence that the transaction was entered into at market terms.

Measurement of nonfinancial assets

The ASU eliminates the terms “in-use” and “in-exchange” in ASC 820 when describing the valuation premise for nonfinancial assets because the Boards believed the terms were often misunderstood and confused with other accounting concepts. While these terms are no longer used, the concept of considering the appropriate valuation premise for nonfinancial assets remains the same. That is, the fair value of a nonfinancial asset considers the perspective of market participants on the asset’s highest and best use either in combination with other assets and liabilities or on a standalone basis.

Under the current guidance in ASC 820, the concept of an “in-use” valuation premise is limited primarily to assets used in combination with other assets. The ASU clarifies that in certain circumstances one might consider the highest and best use of a nonfinancial asset in combination with other assets and liabilities. The ASU does not provide much guidance on the types of liabilities that could be considered complementary to a nonfinancial asset, other than citing liabilities that fund working capital.

How we see it

While the ASU formally introduces the concept of complementary liabilities when measuring the fair value of a nonfinancial asset, we believe this clarification was generally intended to align the guidance in ASC 820 with current practice for measuring the fair value of certain nonfinancial assets (such as intangible assets) where a contributory charge is taken for working capital. We generally do not expect this clarification to result in significant changes to the valuation of most nonfinancial assets.

For example, we continue to believe that real estate should be valued independently from any debt used to finance the property. As a result, the fair value of real estate may be lower than the par value of any nonrecourse debt used to fund the real estate.

Disclosures

New Level 3 disclosures

In response to user demands for additional transparency, the ASU requires additional disclosures for Level 3 fair value measurements. Similar to the existing disclosure requirements in ASC 820, the ASU’s new Level 3 disclosures described below apply to items measured at fair value on the statement of financial position after initial recognition.

Quantitative information about significant unobservable inputs

The ASU requires public and nonpublic companies to disclose the unobservable inputs that are significant to the fair value measurement. That is, companies are now required to quantitatively disclose the unobservable inputs used in their Level 3 measurements. Importantly, this requirement applies to all Level 3 measurements and not just those assets and liabilities measured at fair value on a recurring basis.

For example, a company with asset-backed securities classified in Level 3 would generally disclose the inputs used in its valuation models related to prepayment speed, probability of default and loss given default (assuming these inputs were all unobservable and deemed to be significant to the valuation). Consistent with all of the disclosures in ASC 820, companies are required to present this information separately for each class of asset and or liability based on the nature, characteristics and risks of their Level 3 measurements. As such, we expect that companies will likely disclose both the range and weighted average of the unobservable inputs used across a particular class of Level 3 assets or liabilities.

There is one exception to this disclosure requirement: investments in investment companies whose fair value is estimated using unadjusted net asset value (NAV) as a practical expedient. The FASB provided this exception because it agreed with constituents who pointed out that the classification of these instruments in Level 3 is based on the ability of the reporting entity to redeem its investment, not on the observability of the inputs used to determine NAV.

The ASU addresses situations when significant unobservable inputs are not developed by the company in measuring fair value, such as when a company uses third-party pricing information without adjustment. In these instances, the ASU states that a company is not required to create quantitative information to comply with this disclosure requirement. However, when making these disclosures, companies cannot ignore information about significant unobservable inputs that is “reasonably available.”

We would expect significant unobservable inputs to be reasonably available when a third-party valuation expert is engaged to help a company determine the fair value of its assets. In these instances, the company would likely receive a valuation report that summarizes the techniques and assumptions the valuation specialist used. In some cases, company management may actually provide the specialist with the key assumptions to be used in the valuation.

In contrast, when a company receives price quotes or other valuation information from a third-party pricing service or broker, the specific unobservable inputs underlying this information may not be reasonably available to the company. Companies should begin talking to their service providers about the types of information these service providers can provide to meet this disclosure requirement.

In addition, any adjustments made by a company to the pricing data received from a third-party should be disclosed if these adjustments are not based on observable market data and are deemed to be significant to the overall measurement.

Companies with significant Level 3 measurements may find the new disclosure requirements challenging.

How we see it

Companies with significant Level 3 measurements may find the new disclosure requirements to be operationally challenging. Capturing and disclosing information at a level of disaggregation that is both meaningful and practical will require judgment and may be difficult.

Companies should make reasonable efforts to obtain the information needed to meet this disclosure requirement. Determining whether information is “reasonably available” will require judgment, and there may be some diversity in practice stemming from differences in companies’ access to information and information vendors may be willing or able to provide.

Valuation processes

Public and private companies will also be required to describe the valuation processes they have in place for all Level 3 measurements. The new disclosure requirement is consistent with disclosures recommended by the IASB’s Expert Advisory Panel in its October 2008 report, *Measuring and Disclosing the Fair Value of Financial Instruments in Markets that are No Longer Active*, except that the ASU’s requirement applies to all Level 3 measurements (both recurring and nonrecurring).

The ASU provides the following examples of information companies might provide to comply with this disclosure requirement:

- ▶ A description of the group responsible for valuation policies and procedures, to whom the group reports and the types of internal reporting procedures in place (e.g., interaction between the group and risk management or the audit committee to assess fair value measurements)
- ▶ A description of the frequency and methods for calibration, back testing and other testing procedures used to evaluate pricing models
- ▶ A description of the process for analyzing changes in fair value measurements from period to period
- ▶ A description of the methods used to evaluate pricing information provided by third-party brokers or pricing services
- ▶ A description of the methods used to develop and substantiate the unobservable inputs used in a fair value measurement

Sensitivity to changes in unobservable inputs

The ASU also requires public companies to provide narrative descriptions of the sensitivity of their recurring Level 3 fair value measurements to changes in the unobservable inputs used, if changing those inputs would significantly affect the fair value measurement. Public companies should also describe any interrelationships between these inputs and discuss how they might magnify or mitigate the effect of changes to the unobservable inputs on the fair value measurement.

This disclosure, combined with the quantitative disclosure of significant unobservable inputs, is designed to permit financial statement users to understand the directional effect of certain inputs on an item's fair value and to evaluate whether the company's views about individual unobservable inputs differ from their own. The Boards believe these disclosures can provide meaningful information to users who are not familiar with the pricing models and valuation techniques used to measure a particular class of assets or liabilities (e.g., complex structured instruments).

How we see it

The illustrative example of a narrative sensitivity analysis provided in the ASU is fairly general in nature, particularly because no numbers relating to how the unobservable inputs might be changed, or how such a change would affect fair value, are required to be disclosed. However, companies should avoid over-generalizations that may not hold true in all cases.

Proposed measurement uncertainty disclosures for Level 3 measurements

The Boards had proposed a "measurement uncertainty disclosure" that would have required companies to quantify and present the range of Level 3 values that would have resulted from using other reasonable unobservable inputs (if significantly different from the determined fair value). While similar to the quantitative sensitivity analysis required under IFRS 7⁸ for Level 3 financial instruments, the proposal would have added the complexity of requiring any interrelationships between unobservable inputs to be considered in the analysis.

Based on constituent feedback, the Boards decided to defer a final decision on whether to require these disclosures pending the outcome of additional field-testing and outreach. It is currently unclear when the Boards will reconsider this proposal.

How we see it

We agree with the Boards' decision to conduct more field tests before deciding whether to require the disclosure of the effect of using other reasonable unobservable inputs on Level 3 measurements. This work will help the Boards better understand the costs associated with making these disclosures.

Other new disclosures

In addition to expanding the disclosures for Level 3 measurements, the ASU requires the following new disclosures:

- ▶ Any (not just significant) transfers between Level 1 and Level 2 of the fair value hierarchy (only for public companies)
- ▶ The hierarchy classification for assets and liabilities whose fair value is disclosed only in the footnotes, such as loans carried at amortized cost whose fair values are required to be disclosed in accordance with ASC 825 (only for public companies)
- ▶ The reason nonfinancial assets measured at fair value are being used in a manner that differs from their highest and best use

Private companies are exempt from the first two requirements above. Upon the adoption of ASU 2011-04, they will no longer be required to disclose any information on transfers between Level 1 and Level 2 of the fair value hierarchy. Under current guidance, public and private companies are required to disclose significant transfers between these levels.

How we see it

The requirement to disclose all transfers between Level 1 and Level 2 may pose data-capture issues for some public companies. This amendment will be more challenging to implement for public companies that do not have systems designed to capture all transfers, but instead manually identify only those transfers deemed to be significant.

Effective date and transition

Effective date

The ASU is effective for public companies in interim and annual periods beginning after 15 December 2011. For example, public companies with fiscal years ending on 31 December 2011 would apply the amendments as of 1 January 2012. However, a public company whose fiscal year ends on 31 October 2011 would apply the amendments during the second quarter of its fiscal year (i.e., the quarter ending 30 April 2012) since this is the first interim period beginning after 15 December 2011.

For nonpublic companies, the ASU is effective for annual periods beginning after 15 December 2011 (i.e., year-end 2012 for calendar-year nonpublic companies). Unlike public companies, nonpublic companies may elect to early adopt the ASU.

Transition

All of the amendments in the ASU are applied prospectively. That is, any fair value measurement difference resulting from the adoption of the ASU will be recognized in income in the period of adoption. The new disclosures in the ASU are required only for periods beginning after the effective date. Companies are not required to provide comparative disclosures for periods prior to the effective date.

In addition, in the period of adoption, companies are required to disclose changes in valuation techniques and inputs resulting from applying the ASU and quantify the total effect of these changes, if practicable.

Remaining differences between US GAAP and IFRS

While the amendments converge most of the fair value measurement requirements, certain key differences remain between US GAAP and IFRS.

Practical expedient for alternative investments

ASC 820 provides a practical expedient to measure the fair value of certain investments in investment companies (e.g., investments in hedge funds or private equity funds that do not have readily determinable fair values) using NAV or its equivalent.

The IASB decided not to provide a similar practical expedient in IFRS 13. IFRS does not currently have accounting requirements that are specific to investment companies and therefore the IASB believed it would be difficult to identify when such a practical expedient would be applied, given the different practices companies across the world use to calculate NAV.

This difference may be addressed as part of the IASB's project on Investment Entities.

Recognition of day-one gains and losses

IFRS continues to restrict the recognition of day-one gains and losses when fair value is determined using unobservable inputs. Although fair value is defined as an exit price (which can differ from an entry price), IFRS 13 defers to other IFRSs (such as IAS 39⁹) on whether to recognize any difference between fair value and transaction price at initial recognition.

US GAAP contains no specific requirements regarding the observability of fair value inputs, thereby allowing for the recognition of day-one gains or losses even when the fair value measurement is based on significant unobservable inputs (i.e., a Level 3 measurement).

Fair value of liabilities with a demand feature

The guidance in IFRS on the fair value measurement of a financial liability with a demand feature differs slightly from US GAAP. IFRS 13 states that the fair value of a liability with a demand feature cannot be less than the present value of the amount payable on demand. Under US GAAP, the fair value of a liability with a demand feature is described as the amount payable on demand at the reporting date.

Disclosures

Quantitative sensitivity analysis disclosures for Level 3 financial instruments

IFRS currently requires a quantitative sensitivity analysis disclosure for Level 3 financial instruments. That is, if different inputs could have reasonably been used in place of one or more of the unobservable inputs used to estimate fair value (and those inputs would have significantly changed the fair value measurement), IFRS 7 requires companies to state that fact, disclose the effect on their fair value measurements and describe how they calculated those effects.

No similar disclosure is currently required under US GAAP. However, as described previously, the Boards will revisit whether to require a measurement uncertainty disclosure, which includes a quantitative sensitivity analysis (similar to those currently required under IFRS 7) that considers the interrelationships between the unobservable inputs.

Other Level 3 disclosures

IFRS generally does not allow for derivative assets and liabilities to be presented on a net basis. As such, amounts disclosed for fair value measurements categorized in Level 3 might differ between US GAAP and IFRS (e.g., Level 3 rollforward).

Nonpublic company disclosures

IFRS does not provide disclosure exemptions for nonpublic companies similar to those included in ASU 2011-04. However, certain nonpublic companies reporting under IFRS for Small and Medium-sized Entities are subject to less-stringent presentation and disclosure requirements. As a result, nonpublic companies may be subject to different disclosure requirements under US GAAP and IFRS.

Endnotes:

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- ¹ Accounting Standards Update 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (the ASU), and International Financial Reporting Standard (IFRS) 13, *Fair Value Measurement*
 - ² Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurement*
 - ³ FASB Statement No. 157, *Fair Value Measurements*
 - ⁴ ASC Topic 815, *Derivatives and Hedging*
 - ⁵ ASC Topic 825, *Financial Instruments*
 - ⁶ ASC Topic 946, *Financial Services – Investment Companies*
 - ⁷ Accounting Standards Update 2009-05, *Measuring Liabilities at Fair Value*
 - ⁸ IFRS 7, *Financial Instruments: Disclosures*
 - ⁹ International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*

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Appendix A: Summary of significant amendments to ASC 820

		Current US GAAP	ASU 2011-04
Key changes to existing principles	Measurement of financial instruments	Concepts of "highest and best use" and valuation premise may be applied to financial instruments	"Highest and best use" and valuation premise concepts no longer apply, but financial instruments with offsetting risks may be valued using a measurement exception if certain criteria are met
	Block discounts	Prohibited for Level 1 fair value measurements	Prohibited for all fair value measurements, regardless of hierarchy level
Other amendments and clarifications	Other premiums and discounts	No explicit guidance in ASC 820	Generally applicable when market participants would consider them when transacting for the asset or liability and when not inconsistent with unit of account
	Measurement of liabilities	Use the quoted price of an identical (or similar) liability when traded as an asset	Use inputs consistent with the valuation of an identical liability when held by another party as an asset
	Measurement of own equity instruments	No explicit guidance in ASC 820	Use inputs consistent with the valuation of an identical instrument when held by another party as an asset
	Principal market	Unclear whether market-based or entity-specific volume drove determination	Market with the greatest volume and level of activity for the asset or liability that the company can access (presumed to be where the company normally transacts)
	Market participants	Described as being independent of the reporting entity	Described as being independent of each other
	Valuation premise for nonfinancial assets	"In-use" and "in-exchange" are used to describe valuation premise	"In combination with other assets and (or) liabilities" and "on a standalone basis" are used to describe valuation premise
New disclosures	Level 3 measurements	Description of valuation techniques and inputs used	Quantitative disclosure of significant unobservable inputs used and other additional disclosures (e.g., qualitative sensitivity analysis, valuation processes)
	Transfers between Level 1 and Level 2	Significant transfers between Level 1 and Level 2 of the fair value hierarchy	Public companies: All transfers between Levels 1 and 2 of the fair value hierarchy Nonpublic companies: Transfers between Level 1 and Level 2 no longer required
	Nonfinancial asset used differently from highest and best use	Not required	Disclose reasons why the current use of a nonfinancial asset differs from its highest and best use
	Hierarchy classification for items not presented on the balance sheet	Not required	Hierarchy classification is required for assets and liabilities whose fair value is disclosed only in the footnotes (only public companies)

Appendix B: Questions and interpretive responses

This section provides questions and interpretive responses to issues companies may encounter when applying or considering the effects of the new fair value guidance.

Financial instruments

Question 1 **May Level 1 instruments be included in a portfolio of financial instruments with offsetting risks when calculating the net exposure to a particular market risk?**

We believe Level 1 instruments may be included when using the exception to value financial instruments with offsetting risks. As noted in the example provided in ASC 820-10-35-18K, a reporting entity is allowed to consider the effect of holding futures contracts when evaluating its net exposure to a particular market risk, such as interest rate risk. While Level 1 instruments such as futures contracts may be considered when calculating a company's net exposure to a particular market risk, we believe the quoted price (unadjusted) for these Level 1 instruments should be used when allocating the fair value to the individual units of account for presentation and disclosure purposes, in order to comply with the requirement in ASC 820 that Level 1 instruments be measured at P x Q.

For example, consider a company that is long a forward to sell 100,000 bushels of corn for \$250,000 in one year. To hedge its position, the company "sells" 20 corn futures contracts with a one-year maturity at \$2.30 per 5,000 bushels on the Chicago Mercantile Exchange (CME). (This example assumes that the forward and futures contracts are deemed to be derivative instruments in accordance with ASC 815 and meet the ASU's measurement exception criteria.)

Forward (long):	\$250,000
Futures (short):	\$2.30 x 5,000 x 20 contracts = (\$230,000)
Net position (long):	\$20,000

When valuing its net exposure to commodity risk (i.e., the risk of corn prices fluctuating) under the measurement exception, the company may apply its bid-ask and credit adjustments based on its \$20,000 net long position. However, when allocating the portfolio-level adjustments (i.e., bid-ask and credit adjustments) back to the individual units of account (i.e., forwards and futures), the company would allocate the Level 1 price to the futures contracts.

Net position (long):	\$20,000	
Valuation adjustment:	(\$2,000)	
Adjusted net value:	\$18,000	
		→ Futures: (\$230,000)
		→ Forward: \$248,000

Premiums and discounts

Question 2 May investment companies (such as private equity and hedge funds) value debt and a controlling equity interest in a portfolio company held in the same fund based on enterprise value?

In some cases, an investment company holds debt (with a provision that requires the debt to be repaid at par upon a change in control) and a controlling equity investment in the same portfolio company.

Consider the following example:

Enterprise value	=	\$ 1,600 (controlling basis)
Par value of debt	=	\$ 400 (with a change in control provision)
Fair value of debt	=	\$ 300

Under current practice, both the debt and controlling equity interest are assumed to be sold to the same market participant in the mergers and acquisitions (M&A) market. This hypothetical sale in the M&A market would generally result in the fair value of the debt and controlling equity investment to be equivalent to enterprise value as illustrated below.

Fair value of debt	=	\$ 400 (par value due to change in control)
Fair value of controlling equity	=	enterprise value – par value of debt
	=	\$ 1,200 (\$1,600 – \$400)

We believe the ASU would not change current practice as this approach reflects the characteristics of the items being measured. In addition, market participants would transact in this manner, consistent with their economic best interest.

Contingent consideration

Question 3 Will the ASU affect the way acquirers value contingent consideration that is recognized as a liability in a business combination?

Prior to ASU 2011-04, constituents held different views as to whether ASC 820 allowed an entity to value a contingent consideration liability based on the fair value of the contingent consideration as an asset, because this asset is generally not traded. (ASC 805, *Business Combinations*, requires contingent consideration to be recognized and measured at fair value as part of the purchase consideration for the acquired business.)

Some constituents believed that the fair value of a contingent consideration liability should not be considered from the perspective of another party holding the corresponding asset. These constituents argued that risk-averse market participants would require a risk premium to assume this obligation, similar to an asset retirement obligation (ARO), given the uncertainty associated with the future payout on the liability. Due to the absence of a “market” for the asset, they argued that another party who assumes the liability cannot hedge the uncertainty risk and would therefore demand additional compensation (i.e., risk premium) that would cause the fair value of the liability to exceed the fair value of the corresponding asset. As a result, these constituents believed that the fair value of contingent consideration would be different between the liability holder and the asset holder.

In contrast, other constituents believed that the fair value of a contingent consideration liability should equal its fair value when held as an asset. These constituents pointed to existing guidance in ASC 820 that allows an entity to consider a corresponding asset when valuing a liability whose price is not observable. They noted that the other view is inconsistent with the exit price concept in ASC 820, which they believe assumes an efficient and competitive market where the fundamental principle of “no arbitrage” holds. Further, these constituents argued that the hypothetical market construct in ASC 820 applies to contingent consideration and would provide symmetry between the fair value of contingent consideration as a liability or as an asset.

The Valuation Resource Group (VRG) discussed this issue at its November 2010 meeting and concurred with the second view. The VRG, however, clarified that such an approach would not apply to liabilities that do not have a corresponding asset such as AROs. For these liabilities, a risk premium should be incorporated, increasing the fair value of the obligation.

The amended guidance in ASU 2011-04 reaffirms the VRG’s view by clarifying that, absent a quoted price, the fair value of a liability should be considered from the perspective of another party holding the identical instrument as an asset, even when the asset is not traded. Consistent with the “no arbitrage” premise of the second view, the Boards further explain in their respective Basis for Conclusions that “the fair value of a liability equals the fair value of a properly defined corresponding asset (that is, an asset whose features mirror those of the liability), assuming an exit from both positions in the same market.”