

## FASB expands fair value disclosures

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On Jan. 21, 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, *Improving Disclosures about Fair Value Measurements*. The ASU reports on new disclosure requirements - and clarifications of existing requirements - under Accounting Standards Codification™ (ASC) Subtopic 820-10 (originally issued as FAS 157).

The new rules require companies to provide greater detail about the methods and inputs they use to measure the fair value of assets, bringing U.S. Generally Accepted Accounting Principles (GAAP) in line with International Financial Reporting Standards (IFRS) 7, which already requires similar disclosures.

### The quest for transparency

The goal of ASC 820-10/FAS 157 is to bring greater transparency to financial statements and to provide investors and other financial statement users with better tools for evaluating the quality of reported earnings and predicting future performance. The standard doesn't specify which assets and liabilities must be reported at fair value - that's found elsewhere in the accounting literature. Rather, it establishes a uniform definition of fair value and a framework for measuring it under GAAP. It also requires certain financial statement disclosures regarding fair value.

One of the most significant changes ASC 820-10/FAS 157 made was to measure fair value on the basis of an asset's or liability's *exit* price rather than historical cost or some other *entry* price. Thus, the standard defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." An "orderly" transaction is one that isn't a forced liquidation or distressed sale.

The standard establishes a three-tier valuation hierarchy. Highest priority is given to Level 1 inputs, which are quoted prices in active markets for *identical* assets or liabilities. Lower priority is given to Level 2 inputs, such as prices in active markets for *similar* assets or liabilities. Lowest priority is given to "unobservable" inputs, such as the reporting entity's cash-flow models or other internal data, known as Level 3 inputs.

FASB guidance recognizes that inactive markets may reflect transactions that aren't "orderly" - that is, they involve forced liquidations or distressed sales. Under those circumstances, a company "may determine that observable inputs ... require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement." Determining fair value under these circumstances "may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales."

### The need for full disclosure

ASU 2010-06 reports on new disclosure rules FASB developed in response to demands from investors and other interested parties for more "granular" information regarding fair value. The requirements relate to the following two activities:

1. **Transfers in and out.** The new rules require companies to disclose separately the amounts of significant transfers into and out of Levels 1, 2 and 3, as well as the reasons for such transfers. Previously, these disclosures were limited to transfers into and out of only Level 3. Suppose, for example, that an asset is moved from Level 2 to Level 1 because the market for that asset becomes active again and more accurate price quotes become available. Disclosing this

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change can help financial statement users assess the company's financial position more accurately.

2. **Level 3 activity.** Starting next year, in connection with the reconciliation of beginning and ending balances of recurring Level 3 measurements, companies will be required to provide separate information about purchases, sales, issuances and settlements of financial instruments. In other words, this information must be presented on a *gross* basis rather than lumped together into one *net* number as currently permitted.

FASB believes that a net number - which indicates the overall impact on fair value of purchases, sales, issuances and settlements - is less useful than a disclosure that provides greater detail on the underlying transactions responsible for changes in Level 3 measurements. FASB recognized, however, that some companies - particularly those with significant trading activities - may need to enhance their information systems to comply with this requirement. The board delayed the effective date of this provision to give companies time to make the necessary adjustments.

The new rules also clarify two existing disclosure requirements:

1. **Level of disaggregation.** ASC 820-10 requires companies to break down fair value measurements according to major categories of assets and liabilities. The new rules clarify that companies should, when appropriate, drill down beneath the balance sheet line items and provide disclosures for "each class of assets and liabilities." The level of disaggregation depends on management's judgment regarding the nature and risks of the company's investments. For example, rather than merely disclosing the total value of available-for-sale debt securities, it might be appropriate to provide details about subsets of that category, such as residential mortgage-backed securities, commercial mortgage-backed securities or collateralized debt obligations.

2. **Valuation techniques.** Previously, ASC 820-10 required companies to disclose "the valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques, if any, during the period." FASB has now clarified that these disclosures, for both recurring and nonrecurring measurements, should include valuation techniques (such as the market approach, income approach, cost approach or a combination of approaches) and should also describe the *inputs* used to determine the fair values of each class of assets or liabilities. These disclosures are required for both Level 2 and Level 3 measurements. FASB also clarifies that, if there's been a change in valuation techniques (such as changing from the market approach to the income approach or adding a valuation technique), the company should disclose the change and the reason for making it.

FASB provides several examples of disclosures about the inputs used to measure fair value. Suppose, for example, that an entity has investments in available-for-sale Level 3 residential mortgage-backed securities. In addition to describing the nature of the securities and the underlying loans, the company might also disclose the following significant inputs: yield, probability of default, loss severity and prepayment rates.

### **Sensitivity analysis left out**

FASB's original proposal would have required companies to conduct a sensitivity analysis and to disclose the potential impact on fair value of "reasonably possible alternative Level 3 inputs." This type of sensitivity analysis is required under IFRS 7.

In light of comments expressing concern about the cost and complexity of these disclosures, however, FASB dropped the requirement from the final rule and will revisit the issue as part of its convergence project with the International Accounting Standards Board (IASB). As FASB and IASB move toward uniform international accounting standards, they'll discuss whether the value of sensitivity analysis to investors and other financial statement users justifies the additional cost to reporting entities.

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### **Effective dates, additional amendments**

The new disclosure requirements apply to interim and annual reporting periods beginning after Dec. 15, 2009, with one exception: The new rules regarding purchases, sales, issuances and settlements associated with Level 3 measurements will be effective for fiscal years beginning after Dec. 15, 2010, and for interim periods within those fiscal years.

The ASU also reports on some amendments to ASC 715-20, which covers employer disclosures related to postretirement benefit plan assets. The amendments change some terminology and include a cross reference to ASC 820-10 guidance related to such assets.

If your company is affected by the new rules, please contact Mark Gibbs, CPA, [mgibbs@hlbtr.com](mailto:mgibbs@hlbtr.com), to ensure that you understand what is or will be required. We also can help you develop systems, policies and procedures for gathering, analyzing and presenting the information needed to fulfill your disclosure obligations.