

Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Fair Value Measurements

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. 1201-100

Comment Deadline: September 7, 2004



Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by September 7, 2004. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1201-100. Those without email may send their comments to “Technical Director—File Reference No. 1201-100,” at the address at the bottom of this page. Responses should *not* be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB’s website and will be included in the project’s public record.

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<p style="text-align: center;">Notice for Recipients of This Exposure Draft</p>
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This proposed Statement provides guidance for how to measure fair value. It would apply broadly to financial and nonfinancial assets and liabilities measured at fair value under other authoritative accounting pronouncements. The Board invites comments on all matters in this proposed Statement, particularly on the specific issues discussed below. Respondents need not comment on all of those issues and are encouraged to comment on additional issues. It would be helpful if comments explain the reasons for the positions taken and include any alternatives the Board should consider.

Definition of Fair Value

Issue 1: This proposed Statement would define fair value as “the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties” (paragraph 4). The objective of the measurement is to estimate the price for an asset or liability in the absence of an actual exchange transaction for that asset or liability. Will entities be able to consistently apply the fair value measurement objective using the guidance provided by this proposed Statement together with other applicable valuation standards and generally accepted valuation practices? If not, what additional guidance is needed? (Specific aspects of the guidance provided by this proposed Statement are considered below.)

Valuation Techniques

Issue 2: This proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, for using present value techniques to estimate fair value (Appendix A). Is that guidance sufficient? If not, what additional guidance is needed?

Active Markets

Issue 3: This proposed Statement would clarify that valuation techniques used to estimate fair value should emphasize market inputs, including those derived from active markets. In this proposed Statement, active markets are those in which quoted prices are readily and regularly available; *readily available* means that pricing information is currently accessible and *regularly available* means that transactions occur with sufficient frequency to provide pricing information on an ongoing basis. Is that guidance sufficient? If not, what additional guidance is needed?

Valuation Premise

Issue 4: This proposed Statement would provide general guidance for selecting the valuation premise that should be used for estimates of fair value. Appendix B illustrates the application of that guidance (Example 3). Is that guidance sufficient? If not, what additional guidance is needed?

Fair Value Hierarchy

Issue 5: This proposed Statement would establish a hierarchy for selecting the inputs that should be used in valuation techniques used to estimate fair value. Those inputs differ depending on whether assets and liabilities are identical, similar, or otherwise comparable. Appendix B provides general guidance for making those assessments (Example 4). Is that guidance sufficient? If not, what additional guidance is needed?

Level 1 Reference Market

Issue 6: In this proposed Statement, the Level 1 reference market is the active market to which an entity has immediate access or, if the entity has immediate access to multiple active markets, the most advantageous market. Appendix B provides general guidance for selecting the appropriate reference market (Example 5). Is that guidance sufficient? If not, what additional guidance is needed?

Pricing in Active Dealer Markets

Issue 7: This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. Do you agree? If not, what alternative approaches should the Board consider?

Measurement of Blocks

Issue 8: For unrestricted securities with quoted prices in active markets, many FASB pronouncements (including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*) require that fair value be estimated as the product of a quoted price for an individual trading unit times the quantity held. In all cases, the unit of account is the individual trading unit. For large positions of such securities (blocks) held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries (the Guides) permit fair value to be estimated using blockage factors (adjustments to quoted prices) in limited circumstances. In those cases, the unit of account is a block.

The Board initially decided to address that inconsistency in this proposed Statement as it relates to broker-dealers and investment companies. The Board agreed that the threshold issue is one of determining the appropriate unit of account. However, the Board disagreed on whether the appropriate unit of account is the individual trading unit (requiring the use of quoted prices) or a block (permitting the use of blockage factors). The majority of the Board believes that the appropriate unit of account is a block. However, the Board was unable to define that unit or otherwise establish a threshold criterion for determining when a block exists as a basis for using a blockage factor. The Board subsequently decided that for measurement of blocks held by broker-dealers and certain investment companies, current practice as permitted under the Guides should remain unchanged until such time as the Board fully considers those issues.

For those measurements, do you agree with the Board's decision? If applicable, what approaches should the Board consider for defining a block? What, if any, additional guidance is needed for measuring a block?

Level 3 Estimates

Issue 9: This proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort (Level 3 estimates). Appendix B provides general guidance for applying multiple valuation techniques (Examples 6–8). Is that guidance sufficient? If not, what additional guidance is needed?

Restricted Securities

Issue 10: This proposed Statement would require that the fair value of restricted securities be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction. Appendix B provides general guidance for developing those estimates, which incorporates the relevant guidance in SEC ASR No. 113, *Statement Regarding "Restricted Securities."* Is that guidance sufficient? If not, what additional guidance is needed?

Fair Value Disclosures

Issue 11: This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. Appendix B illustrates those disclosures. This proposed Statement also would encourage disclosures about other similar remeasurements that, like fair value, represent current amounts. The Board concluded that those disclosures would improve the quality of information provided to users of financial statements. Do you agree? If not, why not?

Effective Date

Issue 12: This proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. The Board believes that the effective date provides sufficient time for entities to make the changes necessary to implement this proposed Statement. Do you agree? If not, please explain the types of changes that would be required and indicate the additional time that would be needed to make those changes.

Other Issues

Issue 13: This proposed Statement represents the completion of the initial phase of this project. In subsequent phases, the Board expects to address other issues, including issues relating to the relevance and reliability of fair value measurements and the unit of account that should be used for those measurements. What, if any, other issues should the Board address? How should the Board prioritize those issues?

Public Roundtable Meeting

Issue 14: The Board plans to hold a public roundtable meeting with respondents to the Exposure Draft on September 21, 2004, at the FASB offices in Norwalk. Please indicate whether you are interested in participating in the meeting. If so, comments should be submitted before that meeting.

Summary

This proposed Statement would provide guidance for how to measure fair value. It would apply broadly to financial and nonfinancial assets and liabilities that are measured at fair value under other authoritative accounting pronouncements. The Board expects that the guidance provided by this proposed Statement will be applied together with applicable valuation standards and generally accepted valuation practices, where appropriate.

Reason for Issuing This Proposed Statement

Prior to this proposed Statement, there was limited guidance for applying the fair value measurement objective in generally accepted accounting principles (GAAP). That guidance was dispersed among the many pronouncements that require fair value measurements. Differences in that guidance created inconsistencies which added to the complexity in GAAP. Also, many constituents have raised concerns about the ability to develop reliable estimates of fair value in certain circumstances, in particular, in the absence of quoted prices. In response, the Board decided to develop a framework clarifying the fair value measurement objective and its application under other pronouncements that require fair value measurements. In developing the framework, the Board also considered the need for increased consistency and comparability in fair value measurements and enhanced disclosures about fair value measurements.

Differences between This Proposed Statement and Current Practice

The changes to current practice resulting from the application of this proposed Statement relate principally to the methods for measuring fair value and expanded disclosure requirements. Those changes are summarized below.

This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. It would prohibit the use of the other methods currently allowed under SEC ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies*.

This proposed Statement would require that the fair value of restricted securities (securities for which sale is legally restricted by governmental or contractual requirements for a specified period) be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction. The guidance in this proposed Statement would apply to all restricted securities, including equity securities with restrictions that terminate within one year, which are included in the scope of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

This proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort. In all cases, the valuation techniques used for those estimates would emphasize relevant market inputs, including those derived from active markets.

This proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, for using present value techniques to estimate fair value, thereby elevating that guidance to Level A GAAP. Thus, that guidance would apply under all pronouncements in which present value is used to estimate fair value, including APB Opinion No. 21, *Interest on Receivables and Payables*. This proposed Statement would not amend Concepts Statement 7. The Board expects to consider the need for amendments to Concepts Statement 7 in a subsequent phase of this project.

This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position, including information about the fair value amounts, how those fair value amounts were determined, and the effect of the remeasurements on earnings (including unrealized gains and losses). That information would be presented together with similar information disclosed under other pronouncements.

How the Changes in This Proposed Statement Would Improve Financial Reporting

This proposed Statement establishes a framework for applying the fair value measurement objective in GAAP. Improvements to financial reporting should result from increased consistency, reliability, and comparability. Related improvements should result from the expanded disclosures about the resulting fair value measurements, which should provide information that is useful to users of financial statements in assessing the effects of those measurements used in financial reporting. Also, the amendments made by this proposed Statement would advance the Board's initiatives to simplify and codify the accounting literature.

How the Conclusions in This Proposed Statement Relate to the FASB's Conceptual Framework

In developing the fair value framework, the Board considered the qualitative characteristics discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. Those characteristics emphasize that providing comparable information enables users to identify similarities in and differences between two sets of economic events. The fair value framework also clarifies and incorporates the guidance in Concepts Statement 7 for using present value techniques to estimate fair value.

The expanded disclosures about fair value remeasurements supplement the fair value framework, providing information that is useful to present and potential investors, creditors, and others in making rational investment, credit, and similar decisions—an objective of financial reporting in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*.

The fair value framework should provide the Board with a foundation for making improvements to the measurement guidance in its conceptual framework in a subsequent phase of this project.

Costs and Benefits of Applying This Proposed Statement

Although the guidance in this proposed Statement builds on current practice and requirements, some entities will need to make changes to comply with the requirements of this proposed Statement, thereby incurring one-time costs. However, the benefits from more reliable, consistent, and comparable information about the fair value measurements used in financial reporting should be ongoing.

The Effective Date of This Proposed Statement

This proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2004, and interim periods within those fiscal years. Earlier application would be encouraged. The provisions of this proposed Statement are to be applied prospectively, except for the change in accounting principle relating to bid-asked spread measurements. For that change, this proposed Statement would require a retroactive transition approach applied by reporting a cumulative-effect adjustment.

Proposed Statement of Financial Accounting Standards

Fair Value Measurements

June 23, 2004

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Proposed Statement of Financial Accounting Standards

Fair Value Measurements

June 23, 2004

INTRODUCTION

1. This Statement provides guidance for how to measure fair value. It applies broadly to financial and nonfinancial assets and liabilities that are measured at fair value under other authoritative accounting pronouncements. Appendix E lists pronouncements of the Accounting Principles Board (APB) and Financial Accounting Standards Board (FASB) within the scope of this Statement. The FASB expects that the guidance provided by this Statement will be applied together with applicable valuation standards and generally accepted valuation practices, where appropriate.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

2. This Statement applies to assets and liabilities measured at fair value under other pronouncements, except those listed below:¹
- a. Pronouncements that address share-based payment transactions: APB Opinion No. 25, *Accounting for Stock Issued to Employees*; FASB Statements No. 123, *Accounting for Stock-Based Compensation*, and No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*; FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*; and FASB Technical Bulletin No. 97-1, *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*
 - b. Pronouncements that address leasing transactions: FASB Statements No. 13, *Accounting for Leases*, and No. 98, *Accounting for Leases*; FASB Interpretations No. 23, *Leases of Certain Property Owned by a Governmental Unit or Authority*, and No. 24, *Leases Involving Only Part of a Building*; and FASB Technical Bulletins No. 86-2, *Accounting for an Interest in the Residual Value of a Leased Asset*, and No. 88-1, *Issues Relating to Accounting for Leases*
 - c. Pronouncements that address revenue recognition transactions measured using vendor-specific objective evidence (VSOE) of fair value²

¹This Statement refers to the application of the definition of fair value (paragraph 4) to assets and liabilities. However, it also could be applied to an entity's own equity instruments.

²Specifically, those pronouncements are AICPA Statement of Position 97-2, *Software Revenue Recognition*, as modified by AICPA Statement of Position 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, and EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables."

- d. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*³
- e. ARB No. 43, Chapter 4, “Inventory Pricing.”

3. Appendix D lists APB and FASB pronouncements that are amended by this Statement.

Definition of Fair Value

4. Fair value is the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.

5. The objective of a fair value measurement is to estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability.⁴ Thus, the estimate is determined by reference to a current hypothetical transaction between willing parties. Willing parties are presumed to be marketplace participants representing unrelated buyers and sellers that are (a) knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction, and (b) willing and able to transact in the same market(s), having the legal and financial ability to do so. Fair value presumes the absence of compulsion (duress). Accordingly, the amount that forms the basis for the estimate is the price that would be observed in a transaction other than a forced liquidation transaction or distress sale. In all cases, that price shall be estimated without regard to an entity’s intent to currently enter into such a transaction. (Refer to Example 1 of Appendix B.)

Unit of Account

6. The unit of account defines the boundaries of what is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated), that is, whether individually (for example, a single loan) or as part of a larger group (for example, a portfolio of loans). For estimates of fair value, the unit of account specified in other applicable pronouncements shall be used.⁵ If the unit of account is not specified, it may be determined based on available market inputs (paragraphs 9–12). (Refer to Example 2 of Appendix B.)

³For impaired loans covered by Statement 114, the present value measurement objective is not fair value; however, a fair value measurement results if an observable market price (or fair value of collateral) is used as a practical expedient.

⁴For a liability, the estimate of fair value should consider the effect of the entity’s credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality (discussed in paragraphs A23–A27 of Appendix A).

⁵For example, for unrestricted securities with quoted prices in active markets, many FASB pronouncements (including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*) require that fair value be estimated as the product of a quoted price for an individual trading unit times the quantity held. In all cases, the unit of account is the individual trading unit. However, for large positions of such securities (blocks) held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries permit fair value to be estimated using blockage factors (adjustments to quoted prices) in limited circumstances, based on an assessment of various factors, including the size of the positions held and the liquidity of the market. In those cases, the unit of account is the block. This Statement does not change that existing guidance.

Valuation Techniques

7. Valuation techniques consistent with the market approach, income approach, and cost approach shall be considered for all estimates of fair value.⁶ Key aspects of those approaches are summarized below:

- a. The market approach requires observable prices and other information generated by actual transactions involving identical, similar, or otherwise comparable assets or liabilities (including business enterprises).⁷ The estimate of fair value is based on the value indicated by those transactions.
- b. The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The estimate of fair value is based on the value indicated by marketplace expectations about those future amounts. Those valuation techniques include present value techniques and option-pricing models, such as the Black-Scholes-Merton formula and lattice models, which incorporate present value techniques. (Appendix A discusses the use of present value techniques to estimate fair value.)
- c. For an asset, the cost approach considers the amount that currently would be required to replace its service capacity (often referred to as current replacement cost). The estimate of fair value considers the cost to acquire a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical depreciation, functional obsolescence, and economic obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

8. Valuation techniques used to estimate fair value shall be consistently applied. A change in the valuation technique(s) used is appropriate only if the change results in a more reliable estimate of fair value, for example, as new markets develop or as new and improved valuation techniques become available. Revisions resulting from a change in the valuation technique(s) used shall be accounted for prospectively, as changes in accounting estimates (APB Opinion No. 20, *Accounting Changes*, paragraphs 31–33).

Market Inputs

9. Market inputs refer to the assumptions and data that marketplace participants would use in their estimates of fair value. Valuation techniques used to estimate fair value shall emphasize market inputs, including those derived from active markets, whether using the market approach, income approach, or cost approach.

10. In an active market, such as the New York Stock Exchange, quoted prices that represent actual (observable) transactions are readily and regularly available; *readily*

⁶However, for estimates of fair value that are developed using quoted prices in active markets (an application of the market approach), the results of other valuation techniques may not provide significant additional information (paragraphs 14–24).

⁷For example, paragraph 25 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, refers to the use of valuation techniques consistent with the market approach in determining the fair value of a reporting unit (as defined in that Statement).

available means that pricing information is currently accessible and *regularly available* means that transactions occur with sufficient frequency to provide pricing information on an ongoing basis. In determining whether a market is active, the emphasis is on the level of activity for a particular asset or liability.

11. Markets in which assets and liabilities are exchanged vary in structure and level of activity. Examples of such markets include the following:

- a. *Exchange market.* An exchange market provides high visibility and order to the trading of financial instruments. Typically, closing prices are readily and regularly available. In an exchange market, multiple identical exchange units are traded. An example of such a market is the New York Stock Exchange.
- b. *Dealer market.* In a dealer market, dealers stand ready to trade (either buy or sell for their own account), thereby providing liquidity by using their capital to hold an inventory of the items for which they make a market. Typically, bid and asked prices are more readily and regularly available than closing prices. In a dealer market, multiple identical exchange units are traded. “Over-the-counter” markets (where prices are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by the National Quotation Bureau) are dealer markets. For example, the market for U.S. Treasury securities is a dealer market. Dealer markets also exist for other assets and liabilities, such as financial instruments, commodities, and physical assets (for example, certain used equipment).
- c. *Brokered market.* In a brokered market, brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. In other words, brokers do not use their own capital to hold an inventory of the items for which they make a market. The broker knows the prices bid and asked by the respective parties, but each party is typically unaware of another party’s price requirements. Prices of completed transactions are sometimes available. Brokered markets include electronic communication networks (ECNs), in which buy and sell orders are matched, and commercial and residential real estate markets.
- d. *Principal-to-principal market.* Principal-to-principal transactions, both originations and resales, are negotiated independently with no intermediary. Little information about those transactions may be released publicly.

12. Market inputs shall be determined based on information that is timely, originated from sources independent of the entity, and used by marketplace participants in making pricing decisions. Examples of market inputs that may be used, directly or indirectly as a basis for deriving other relevant inputs, include the following:

- a. Quoted prices (whether quoted in terms of completed transaction prices, bid and asked prices, or rates), adjusted as appropriate. The fair value hierarchy (paragraphs 14–24) specifies whether and, if so, when adjustments to those prices are appropriate.
- b. Information about interest rates, yield curve, volatility, prepayment speeds, default rates, loss severity, credit risk, liquidity, and foreign exchange rates.

- c. Specific and broad credit data and other relevant statistics (industry and other), including a current published index.

Valuation Premise

13. A valuation premise specifies the condition and location of many assets, including whether assets are installed or integrated with other assets (that is, configured for use by an entity). It provides additional information about the asset being measured and the assumptions that marketplace participants would use in their estimates of fair value. A going-concern or in-use valuation premise presumes that marketplace participants would continue to use (a) a business that is a going concern or (b) an asset that is configured for use by an entity. In those situations, a going-concern or in-use valuation premise is generally appropriate. Otherwise, an in-exchange valuation premise may be appropriate. An in-exchange valuation premise presumes that an asset is not configured for use by an entity and that marketplace participants would sell the asset. In either case, the estimate of fair value would consider the related assumptions and data that marketplace participants would use. (Refer to Example 3 of Appendix B.)

Fair Value Hierarchy

14. The fair value hierarchy groups into three broad categories (levels) the inputs that should be used to estimate fair value. The hierarchy gives the highest priority to market inputs that reflect quoted prices in active markets for identical assets and liabilities (whether such prices are quoted in terms of completed transaction prices, bid and asked prices, or rates) and the lowest priority to entity inputs developed based on an entity's own internal estimates and assumptions. (Refer to Example 4 of Appendix B.)

Level 1 Estimates

15. Fair value shall be estimated using quoted prices for identical assets or liabilities in active reference markets whenever that information is available. Quoted prices used for a Level 1 estimate shall not be adjusted.

16. For an identical asset or liability, the Level 1 reference market is the active market to which an entity has immediate access (in many cases, the principal trading market for the asset or liability being measured). *Immediate access* means that an entity could exchange the asset or liability in its current ("as-is") condition at the quoted price in that market within a period that is usual and customary for transactions involving such assets or liabilities. If the entity has immediate access to multiple active markets with different prices, the Level 1 reference market is the most advantageous market, that is, the market with the price that maximizes (or minimizes) the net amount that would be received (or incurred) in a current transaction for an asset (or liability). For purposes of determining the most advantageous market, costs to transact in the respective markets shall be considered. However, the price used to estimate fair value, that is, the price in the most advantageous market, shall not be adjusted for those costs. Transaction costs shall be accounted for in accordance with the provisions of other applicable pronouncements, generally in the period incurred. (Refer to Example 5 of Appendix B.)

17. In an active dealer market where bid and asked prices are more readily and regularly available than closing prices, fair value shall be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities). For offsetting positions, mid-market prices shall be used for the matched portion. Bid and asked prices shall be used for the net open position, as appropriate.⁸

18. In some cases in which significant events (for example, principal-to-principal or brokered trades or significant announcements) occur after the close of the market but before the end of the reporting period, the closing price in that market might not be representative of fair value. An entity should establish and consistently apply a policy for determining how those events affect estimates of fair value.

Level 2 Estimates

19. If quoted prices for identical assets or liabilities in active markets are not available, fair value shall be estimated using quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences, whenever that information is available.

20. For a Level 2 estimate, the price effect of the differences must be objectively determinable. For example, an observed price of securitized receivables can be used as a basis for estimating the fair value of unsecuritized receivables of the same type, but only if the price effect of the securitization (the price effect of the liquidity, security, and other benefits added by securitization) is objectively determinable. Otherwise, the estimate is a Level 3 estimate.

Level 3 Estimates

21. If quoted prices for identical or similar assets or liabilities in active markets are not available, or if differences between similar assets or liabilities are not objectively determinable, fair value shall be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort.

22. Level 3 estimates require judgment in the selection and application of valuation techniques and relevant inputs. If multiple valuation techniques are used, the results of those techniques (that is, the respective indications of fair value) shall be evaluated, considering the relevance and reliability of the inputs used. (Refer to Examples 6–8 of Appendix B.) If information necessary to apply multiple valuation techniques is not available without undue cost and effort, the valuation technique that best approximates what an exchange price would be in the circumstances shall be used.

23. Valuation techniques used for Level 3 estimates shall emphasize market inputs, including quoted prices generated by actual (observable) market transactions, adjusted as

⁸Other pronouncements specify whether and, if so, when such offsetting is appropriate. This Statement does not change that guidance.

appropriate.⁹ The reasons for adjustments to quoted prices will vary. Examples include the following:

- a. A price might not be sufficiently current for a Level 1 or Level 2 estimate (stale price). In determining whether a price is stale, an entity should consider the timing of the actual transaction, the frequency of other similar transactions, changes in credit conditions, interest rates, and other market conditions during the intervening period and other relevant factors.
- b. The price effect of differences between similar assets (liabilities) might not be sufficiently determinable for a Level 2 estimate.
- c. A price might be quoted in terms of bid and asked prices in a less active market (where the spread between the bid and asked prices is relatively wide).
- d. The underlying transaction might not be representative of a marketplace transaction. That could be the case if, for example, the transaction (1) occurred under duress (in a forced liquidation transaction or distress sale), (2) was between related parties, or (3) was part of a series of other simultaneous planned or recent transactions between the parties and would have occurred at a different price if not for those other transactions.
- e. Contractual terms might affect the total transaction price (for example, contingent consideration).
- f. A price might need to be adjusted for differences in the unit of account, condition, or location, or to reflect the appropriate valuation premise.

Level 3 Estimates with Significant Entity Inputs

24. In some cases, market inputs might not be available without undue cost and effort, requiring the use of significant entity inputs derived from an entity's own internal estimates and assumptions. In those cases, valuation techniques that rely on significant entity inputs may be used for Level 3 estimates, but only as a practical expedient (the fair value measurement objective remains the same) and to the extent that such estimates are not precluded under other applicable pronouncements.

Disclosures

25. For each interim and annual period for which a statement of financial position is presented, an entity shall disclose the following information about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position, incorporating similar information disclosed under other pronouncements (refer to Appendix B):

- a. For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities) (1) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities, (2) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent

⁹Paragraph 12 refers to examples of other market inputs that may be relevant for Level 3 estimates.

to which market inputs were used), and (3) the effect of the remeasurements on earnings for the period (unrealized gains or losses) relating to those assets and liabilities still held at the reporting date.

- b. For assets and liabilities that are remeasured at fair value on a nonrecurring (or periodic) basis during the period (for example, impaired assets), a description of (1) the reason for the remeasurements, (2) the fair value amounts, (3) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and (4) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.

26. Disclosures about other similar remeasurements (for example, inventories remeasured at “market value” under ARB 43, Chapter 4) are encouraged but not required.

Effective Date and Transition

27. This Statement shall be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. Earlier application is encouraged. Initial application of this Statement shall be as of the beginning of an entity’s fiscal year. If this Statement is initially applied during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated. Restatement of previously issued annual financial statements is not permitted.

28. This Statement shall be applied prospectively, except as follows. The effect of initially applying paragraph 17 of this Statement shall be reported as the cumulative effect of a change in accounting principle (Opinion 20, paragraph 20). Pro forma disclosure of the effect of the change in accounting principle in periods presented prior to initial application of this Statement is encouraged but not required. In the period in which this Statement is initially applied, an entity shall disclose the effect of the change in accounting principle on income before extraordinary items and on net income (and related per-share amounts).

29. The disclosure requirements of this Statement (paragraphs 25 and 26) need not be applied for financial statements for periods presented prior to initial application of this Statement.

<p style="text-align: center;">The provisions of this Statement need not be applied to immaterial items.</p>

Appendix A

PRESENT VALUE TECHNIQUES

Introduction

A1. In the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value shall be estimated based on the results of multiple valuation techniques whenever the information necessary to apply those techniques is available without undue cost and effort (a Level 3 estimate). A present value technique may be used to estimate fair value (an application of the income approach). Present value is a tool used to link future amounts (cash flows) to the present through a discount rate. Present value is one of the foundations of economics and finance and is part of most asset-pricing models, including option-pricing models. Moreover, the present value of future cash flows is implicit in the market prices of assets and liabilities recognized in the financial statements.

A2. A fair value estimate, using present value, should capture the following elements that taken together would make up the price at which an asset or liability could be exchanged in a transaction between knowledgeable, unrelated willing parties:

- a. An estimate of future cash flows
- b. Possible variations in the amount and (or) timing of the cash flows
- c. The price for bearing the uncertainty inherent in the cash flows
- d. The time value of money, represented by the risk-free interest rate
- e. Other case-specific factors, such as liquidity and market imperfections
- f. In the case of a liability, the effect of an entity's creditworthiness (discussed in paragraphs A23–A27).

A3. Present value techniques differ in how they incorporate those elements. This appendix discusses two present value techniques—a discount rate adjustment technique (paragraphs A9–A11) and an expected present value technique (paragraphs A12–A19).¹⁰ Regardless of the technique used, certain general principles govern:

- a. Cash flows and discount rates should reflect assumptions that marketplace participants would use in their estimates of fair value.
- b. Cash flows and discount rates should consider only factors related to the asset (or liability) being measured.
- c. To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions about risk that are not otherwise considered in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using contractual cash flows of a loan (discount rate adjustment technique), but not if using expected (probability-weighted) cash flows (expected

¹⁰FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, describes these present value techniques but uses different terms. In Concepts Statement 7, traditional present value refers to a discount rate adjustment technique, while expected cash flow approach refers to an expected present value technique.

present value technique) because expected cash flows already reflect assumptions about future defaults.

- d. Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effect of inflation) should be discounted at a rate that includes the effect of inflation.¹¹ Similarly, real cash flows (that exclude the effect of inflation) should be discounted at a rate that excludes the effect of inflation.
- e. Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

Risk and Uncertainty

A4. Like other estimates, a fair value estimate, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, the amount and timing of the cash flows will be uncertain. Even contractual amounts, like the payments on a loan, will be uncertain if there is risk of default.

A5. Marketplace participants generally seek compensation for bearing the uncertainty inherent in cash flows (risk premium).¹² For example, marketplace participants will place a higher value on an asset with promised (contractual) cash flows and no uncertainty than on an asset with expected cash flows of the same amount that are uncertain. The lower value reflects compensation for bearing risk. Similarly, marketplace participants will demand more to assume a liability with cash flows that are uncertain than a liability with cash flows of the same amount and no uncertainty. The higher value reflects compensation for bearing risk. An estimate that excludes compensation for bearing risk would not faithfully represent fair value if it is apparent that marketplace participants would seek compensation for bearing that risk.

A6. The objective of including risk in the estimate of fair value is to replicate the market's behavior toward assets and liabilities with uncertain cash flows, using as a benchmark the rate on monetary assets that are essentially risk free and that have maturity dates or durations that coincide with the period covered by the cash flows (risk-free interest rate). For present value computations denominated in U.S. dollars, U.S. Treasury securities often provide such a benchmark because they are assumed to pose neither

¹¹The risk-free interest rate generally includes the effect of inflation (nominal discount rate).

¹²Portfolio theory distinguishes between (a) risk specific to a particular asset (or liability) that can be avoided through diversification when that asset (or liability) is held in a portfolio together with other assets (and liabilities) having different risk properties (nonsystematic or diversifiable risk) and (b) risk specific to a particular asset (or liability) that cannot be diversified (systematic or nondiversifiable risk). Specifically, portfolio theory holds that in a market in equilibrium, marketplace participants (investors) will be compensated only for bearing the systematic or nondiversifiable risk inherent in the cash flows.

uncertainty in timing nor risk of default to the holder.¹³ Other securities, such as those issued by riskier counterparties, have varying degrees of default (and other) risk, and marketplace participants demand more for bearing that risk.

A7. To illustrate the concept of risk, consider two 10-year assets. Asset A is a U.S. Treasury security with promised (contractual) cash flows of \$10,000 and no uncertainty. Asset B is a different security with cash flows that are uncertain, ranging from \$8,000 to \$12,000. For Asset B, uncertainty is incorporated in the expected cash flows (discussed in paragraph A13), which assuming events of equal magnitude and probability above and below the mean (symmetric probability distribution), are \$10,000. Thus, for both assets, the expected cash flows are the same. However, Asset A has a certain payoff (no dispersion of possible outcomes about its expected amount), while Asset B has an uncertain payoff (dispersion of possible outcomes about its expected amount). If the risk-free interest rate for 10-year instruments is 5 percent, a marketplace participant would pay about \$6,139¹⁴ for Asset A and something less for Asset B, depending on the price (risk premium) that marketplace participants would demand for bearing the uncertainty inherent in the cash flows.

Present Value Techniques

A8. For a fair value estimate, the present value technique used depends on circumstances relevant to the asset (or liability) being measured. For example, the discount rate adjustment technique may be useful when prices for similar assets (or liabilities) with similar uncertainties can be observed in the marketplace. If prices for similar assets (or liabilities) cannot be observed in the marketplace, an expected present value technique often will be a more effective measurement tool.

Discount Rate Adjustment Technique

A9. The discount rate adjustment technique uses a single set of cash flows from the range of possible estimated amounts. For example, such cash flows might be contractual cash flows or, if contractual cash flows are not available, the single, most-likely amount in a range of possible estimated amounts (best estimate). The cash flow(s) are discounted at a rate commensurate with the risk inherent in the cash flow(s) (risk-adjusted discount rate).

A10. The discount rate adjustment technique does not explicitly link the risk in the cash flows and the discount rate. Rather, because discount rates should reflect assumptions about risk that are not otherwise considered in the cash flows, the discount rate adjustment technique is based on the assumption that the discount rate can fully incorporate the risk inherent in the cash flows. Accordingly, the risk-adjusted discount rate must be derived from some other comparable asset (or liability) whose price and other relevant attributes can be observed in the marketplace. Those other relevant attributes include the nature of

¹³A yield curve for U.S. Treasury securities may be used to determine the appropriate risk-free interest rates.

¹⁴\$6,139 is the present value of \$10,000 discounted for 10 years at 5 percent.

the cash flows (for example, whether the cash flows are contractual or otherwise estimated and whether the cash flows are likely to respond similarly to changes in economic conditions), as well as credit standing, collateral, restrictive covenants, and liquidity. If a single asset (or liability) does not fully incorporate the risk inherent in the cash flows of the asset (or liability) being measured, it may be possible to derive a discount rate using an approach that uses data for several comparable assets (or liabilities) in conjunction with the risk-free yield curve (“build-up” approach).

A11. To illustrate the application of the discount rate adjustment technique, assume that Asset A will pay an uncertain amount in one year (no timing uncertainty). The best (most likely) estimate of that amount is \$800. There is an established market for comparable assets, and information about those assets, including price information, is disclosed. Of those comparable assets:

- a. Asset B has a best estimate payment of \$1,200 in 1 year, a market price of \$1,083, and an implied annual rate of return of 10.8 percent $[(\$1,200/\$1,083) - 1]$.
- b. Asset C has a best estimate payment of \$700 in 2 years, a market price of \$566, and an implied annual rate of return of 11.2 percent $[(\$700/\$566)^{0.5} - 1]$.
- c. All three assets are comparable with respect to risk (dispersion of possible payoffs and credit rating).

Based on the timing of the payments (one year for Asset B versus two years for Asset C), Asset B is deemed more similar to Asset A. Using the best estimate payment for Asset A (\$800) and a risk-adjusted discount rate derived from Asset B (10.8 percent), the fair value of Asset A is \$722 $(\$800/1.108)$.¹⁵

Expected Present Value Technique

A12. The expected present value technique begins with a set of cash flows that, in theory, represents the sum of all possible cash flows, each weighted by its probability, that is, the probability weighting of all possible outcomes (expected cash flows).¹⁶ It then reflects the market required risk premium for the risk inherent in the expected cash flows (not otherwise reflected in the cash flows) using one of two methods. Under Method 1, the expected cash flows are explicitly adjusted (reduced) for risk (risk-adjusted expected cash flows) and discounted at a risk-free interest rate, similar to a certainty-equivalent cash

¹⁵In the absence of available market information for Asset B, the risk-adjusted discount rate could be derived from Asset C using the “build-up” approach referred to in paragraph A10. In that case, the two-year discount rate indicated by Asset C would be adjusted to a one-year discount rate based on the term structure of the risk-free yield curve. Additional information and analysis also might be required to determine if the risk premium for one-year and two-year assets is the same. If they are not the same, the two-year discount rate also would be adjusted for that difference (based on additional analysis).

¹⁶The resulting estimate is identical to *expected value*, which, in statistical terms, is the weighted average of a discrete random variable’s possible values where the respective probabilities are used as weights. The expected value of a continuous random variable is that variable’s possible values weighted by the respective probabilities.

flow for an asset.¹⁷ Under Method 2, the expected cash flows are discounted using a rate commensurate with the risk inherent in the expected cash flows (risk-adjusted discount rate).¹⁸ In other words, an expected present value technique requires an adjustment for risk in either the expected cash flows or the discount rate depending on whether Method 1 or Method 2 is applied.

A13. Unless the distribution of possible outcomes is symmetrical around its expected value (mean), the expected cash flows used in the expected present value technique will differ from the single best estimate cash flows used in the discount rate adjustment technique. The difference between the expected cash flows and the single best estimate depends on the shape of the distribution of possible outcomes. To the extent the cash flows used in those techniques are different, the risk-adjusted discount rates also will be different because the risks in the cash flows differ; however, the estimated fair values should be the same.

A14. In some situations, accounting estimates may incorporate elements of expected cash flows, considering the likelihood of possible outcomes (probability assessments) as follows:

- a. The estimated amount falls somewhere between \$50 and \$250, but no amount in the range is more likely than any other amount (representing a uniform distribution). Based on that limited information, the expected cash flow is \$150 $[(50 + 250)/2]$. In this case the single best estimate (most likely) cash flow cannot be determined because each possible outcome is equally likely.
- b. The estimated amount will be \$50 with a 10 percent probability, \$250 with a 30 percent probability, or \$100 with a 60 percent probability (representing a discrete distribution). Based on that limited information, the expected cash flow is \$140 $[(50 \times .10) + (250 \times .30) + (100 \times .60)]$. In this case the single best estimate (most likely) cash flow is \$100 because it has the highest probability (60 percent).

A15. In contrast to the situations referred to above, most fair value estimates involve possible cash flows over multiple periods with varying degrees of uncertainty in both amounts and timing. For those more complex measurements, the expected present value technique, which considers expectations about all possible cash flows (amounts and timing), often will be a more effective measurement tool, especially if similar assets (or liabilities) cannot be observed in the marketplace.

A16. For example, assume that an asset has expected cash flows of \$780 in 1 year based on the possible cash flows and probabilities shown below:

¹⁷A *certainty-equivalent cash flow* refers to an expected cash flow (as defined) adjusted for risk such that one is indifferent to trading a certain cash flow for an expected cash flow. For example, if one were willing to trade an expected cash flow of \$1,200 for a certain cash flow of \$1,000, the \$1,000 is the certainty equivalent of the \$1,200. In that case, one would be indifferent as to the asset held.

¹⁸Models used for pricing risky assets, such as the Capital Asset Pricing Model, can be used to estimate a risk-adjusted discount rate.

Possible Cash Flows	Probability	Probability-Weighted Cash Flows
\$500	15%	\$75
\$800	60%	\$480
\$900	25%	\$225
Expected cash flows		\$780

The applicable risk-free interest rate for cash flows with a 1-year horizon is 5 percent, and the risk premium (for systematic or nondiversifiable risk) is 3 percent.

A17. Using the expected present value technique, the expected present value (fair value) of the asset is \$722, whether under Method 1 or Method 2.

- a. Under Method 1, the expected cash flows are explicitly adjusted for risk. Using the concept of certainty equivalents, the risk adjustment (based on the risk premium of 3 percent) is \$22 ($\$780 - [\$780 \times (1.05/1.08)]$), which results in risk-adjusted expected cash flows of \$758 ($\$780 - \22). In that case, the \$758 is the certainty equivalent of \$780 and is discounted at the risk-free interest rate (5 percent). The expected present value (fair value) is \$722 ($\$758/1.05$).
- b. Under Method 2, the expected cash flows are discounted at a risk-adjusted discount rate of 8 percent (the 5 percent risk-free interest rate plus the 3 percent risk premium). The expected present value (fair value) is \$722 ($\$780/1.08$).

A18. Both Methods 1 and 2 yield the same result—an expected present value (fair value) of \$722. That same result could be achieved using the discount rate adjustment technique, but only if the best estimate cash flows (\$800) are discounted at a rate of 10.8 percent ($\$800/\722 or 1.108). Although the discount rate of 10.8 percent can be derived from the prior results (in effect, reverse-engineered), it is not possible to determine whether the 10.8 percent discount rate is appropriate or to otherwise support its derivation without reference to a similar asset in the marketplace.

A19. The set of cash flows used for the expected present value technique, in theory, represents the probability weighting of all possible outcomes (paragraph A12). However, an entity does not need to consider distributions of all possible cash flows using complex models and techniques in order to apply an expected present value technique. Rather, even in cases in which an entity has access to limited data, it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows without using complex models and techniques. In developing those scenarios, an entity might use realized cash flows for some past period, adjusted for changes in circumstances occurring subsequently (such as changes in economic conditions, industry trends, and competition), and incorporating the assumptions of marketplace participants. Each application of the expected present value technique will differ based on the facts and circumstances of each measurement situation, available information, and judgments applied. Such judgments include determining whether to apply a continuous or discrete

probability distribution and, if a discrete probability distribution is applied, the number of discrete scenarios.

Present Value in the Measurement of Liabilities

A20. The present value techniques discussed in this appendix apply to liabilities as well as to assets. However, application of those techniques to liabilities requires that the risk adjustment to the discount rate or cash flows reflect an entity's credit standing.

A21. Some liabilities are held by others as assets, for example, an entity's notes or bonds payable. To estimate the fair value of such liabilities, an entity attempts to estimate the price at which other entities are willing to hold its liabilities as assets. That process involves the same techniques and computational issues involved in measuring assets. For example, the proceeds from a loan are the price that a lender paid to hold the borrower's promise of future cash flows as an asset. Similarly, the fair value of a bond payable is the price at which that security trades, as an asset, in the marketplace. Accordingly, in the application of an expected present value technique to estimate the fair value of such liabilities, the compensation that marketplace participants demand for bearing uncertainty unrelated to credit standing will typically be reflected as a decrease to the expected cash flows.

A22. Other liabilities represent rights that generally cannot be sold (by their holders) like other assets. For example, entities often sell products with an accompanying warranty. Buyers of those products rarely have the ability or inclination to sell the warranty separately from the covered asset, but they own a warranty asset nonetheless. Some of an entity's liabilities, like an obligation for environmental cleanup, are not the assets of identifiable individuals. However, such liabilities are sometimes settled through assumption by a third party. In estimating the fair value of such liabilities, the objective is to estimate the price that the entity would have to pay a third party of equal credit standing to assume the liability. Accordingly, when using an expected present value technique to estimate the fair value of such liabilities, the compensation that marketplace participants demand for bearing uncertainty unrelated to credit standing will typically be reflected as an increase to the expected cash flows.

Credit Standing and Liability Measurement

A23. Those who hold the entity's obligations as assets incorporate the entity's credit standing in determining the prices they are willing to pay. When an entity incurs a liability in exchange for cash, the role of its credit standing is easy to observe. An entity with a strong credit standing will receive more cash, relative to a fixed promise to pay, than an entity with a weak credit standing. For example, if 2 entities both promise to pay \$500 in 5 years, the entity with a strong credit standing may receive about \$374 in exchange for its promise (a 6 percent interest rate). The entity with a weak credit standing may receive about \$284 in exchange for its promise (a 12 percent interest rate). Each entity initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates that entity's credit standing.

A24. The effect of an entity's credit standing on the fair value of its liabilities depends on the ability of the entity to pay and on other provisions of those liabilities that protect holders. Liabilities that are guaranteed by governmental bodies (for example, many bank deposit liabilities in the United States) may pose little risk of default to the holder. Other liabilities may include sinking-fund requirements or significant collateral. Such aspects must be considered in estimating the extent to which the entity's credit standing affects the fair value of its liabilities.

A25. The role of the entity's credit standing in a settlement transaction is less direct but equally important. A settlement transaction involves three parties—the entity, the parties to whom it is obligated, and a third party. The price of the transaction will reflect the competing interests of each party. For example, suppose Entity A (obligor) has an obligation to pay \$500 to Entity B (obligee) 3 years hence. Entity A has a poor credit rating and therefore borrows at a 12 percent interest rate.

- a. In a settlement transaction, Entity B would never consent to replace Entity A with an entity of lower credit standing. All other things being equal, Entity B might consent to replace Entity A with a borrower of similar credit standing and would probably consent to replace Entity A with a more creditworthy entity.
- b. Entity C has a good credit rating and therefore borrows at a 6 percent interest rate. It might willingly assume Entity A's obligation to Entity B for \$420 (the present value at 6 percent). Entity C has no incentive to assume the obligation for less (a higher interest rate) if it can borrow at 6 percent because it can receive \$420 for an identical promise to pay \$500.
- c. However, if Entity A were to borrow the money to pay Entity C, it would have to promise the lender \$590 (\$420 with accumulated interest at 12 percent) due in 3 years.

A26. Based on the example above, the fair value of Entity A's liability should be approximately \$356 (the present value of \$500 in 3 years at 12 percent). The \$420 price demanded by Entity C includes the fair value of Entity A's liability (\$356) plus the price of an upgrade in the credit quality of the liability. Like the purchase of a guarantee, the additional amount represents a separate element of a new arrangement rather than an element of the fair value of Entity A's original liability.

A27. The effect of an entity's credit standing on the measurement of its liabilities is usually captured in an adjustment to the discount rate. However, an expected present value technique, which considers possible cash flows in the measurement, may be useful in considering the effect of credit standing on liabilities other than debt. For example, a liability may subject the entity to a range of possible outflows, ranging from very low to very high amounts. The higher the amount, the greater the chance of default. In those situations, the effect of possible cash flows on an entity's credit standing may be effectively incorporated in the computation of those expected cash flows.

Relationship to Accounting for Loss Contingencies

A28. For a liability measured at fair value, the guidance in FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, does not apply. Both Statement 5 and a fair value measurement consider uncertainty inherent in future cash flows (amount and timing). However, Statement 5 considers uncertainty in the context of recognition, establishing a probability threshold for when to recognize a loss contingency. In contrast, a fair value measurement considers uncertainty in the context of measurement, incorporating uncertainty directly in the measurement.¹⁹

¹⁹Paragraphs 55–61 of Concepts Statement 7 discuss the differences between recognition of a loss contingency under Statement 5 and measurement of a liability at fair value (using expected cash flows).

Appendix B

IMPLEMENTATION GUIDANCE

Introduction

B1. This appendix describes in general terms certain provisions of this Statement and provides examples that illustrate the application of those provisions using simplified assumptions, which are considered in the context of the entity performing the valuation (the “valuer”). Actual valuation situations are likely to be more complex, requiring extensive data gathering and detailed analyses. The Board expects that the provisions of this Statement will be applied together with applicable valuation standards and generally accepted valuation practices, where appropriate. This appendix is an integral part of this Statement.

Fair Value versus Investment Value

B2. Fair value reflects value in the market and is determined based on the assumptions of marketplace participants (willing buyers and sellers). In contrast, investment value reflects value to a particular investor (buyer or seller) and is often considered from the perspective of that investor as a basis for making investment (buy and sell) decisions. Differences between fair value and investment value may be attributable to varying factors, including synergies. Synergies refer generally to the benefits of combining two or more assets or asset groups (for example, operating units) and fall into two broad categories: (a) synergies generally available to all marketplace participants (marketplace synergies) and (b) synergies specific to a particular buyer not generally available to other marketplace participants (buyer-specific synergies).

Example 1

B3. Conceptually, buyer-specific synergies are inconsistent with fair value and would only be included in investment value. However, in a competitive bidding situation involving multiple potential buyers in which both marketplace and buyer-specific synergies are present, the respective bids likely would be determined based on some combination of the synergies available to each of the potential buyers. Example 1 considers that situation for a “target” company that is a consumer goods company with a single high-profile product. In that case, a potential buyer that has a product that uniquely complements the target company’s product, but is less well known, might be willing to pay more than the other potential buyers if the joint marketing of those products would benefit that potential buyer to a greater degree than it would the other potential buyers. If so, the “winning” bid (price paid) would include a premium over the other bids. That premium would not necessarily reflect the value of the synergies. Nor would it necessarily reflect an overpayment. Rather, that premium would reflect the amount that the particular buyer is willing to pay over the other bids to acquire those synergies. The price, determined in an exchange between unrelated willing parties (buyers and sellers), would represent fair value.

Unit of Account

B4. The unit of account defines the boundaries of what is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated). If the unit of account is not specified by an existing pronouncement, the unit of account may be determined based on available market inputs.

Example 2

B5. Example 2 illustrates that situation for a Level 3 estimate involving a customer relationship asset recently acquired in a business combination that meets the criteria for recognition as an asset apart from goodwill. For that customer relationship asset, the valuer estimates fair value using a present value technique (an application of an income approach). The estimates of cash flows used in that technique consider market factors specific to the customers, including expected customer termination behavior, which is important in determining the period for which cash flows will be received (cash flow estimation period). Based on an analysis of relevant market data relating to past customer terminations, the valuer determines that the amount and timing of related future cash flows can be more reliably estimated for the customers as a group than for each customer individually. Thus, the estimate of fair value for the customer relationship asset would be determined for the customers as a group, that is, all customer relationships would be aggregated.

Valuation Premise

B6. A valuation premise specifies the condition and location of many assets and should be considered in estimates of fair value. A going-concern or in-use valuation premise (which includes installation costs) is generally appropriate if (a) a business is a going-concern or (b) an asset is configured for use by an entity. An in-exchange valuation premise (which excludes installation costs) may be appropriate if an asset is not configured for use by an entity.

Example 3

B7. Example 3 illustrates the application of a valuation premise to estimate the fair value of a machine recently acquired in a business combination using a market approach.

- a. If the machine is installed and will continue to be used in income-producing activities of the combined entity, the valuer would use an in-use valuation premise to estimate fair value. In applying a market approach, the valuer would use quoted prices for similar used machines that are not installed (on the loading dock), adjusted for installation costs (to reflect prices for similar used machines that are installed).
- b. If the machine is installed but will be sold by the combined entity (because the acquisition of that asset was incidental to the acquisition of the other assets), the valuer would use an in-exchange valuation premise to estimate fair value. In that case, other marketplace participants would be expected to similarly sell the asset.

In applying a market approach, the valuer would use the quoted prices for similar used machines that are not installed (on the loading dock), unadjusted.

Assessment of Identical, Similar, or Otherwise Comparable Assets and Liabilities

Example 4

B8. Whether and, if so, when adjustments to quoted prices are appropriate depends on whether assets and liabilities are identical, similar, or otherwise comparable.²⁰ Example 4 illustrates factors that might be considered in making those assessments for estimates of fair value. Although considered in the context of attributes relevant to financial instruments with quoted prices in active markets, relevant factors would similarly be considered for other types of assets and liabilities.

- a. If the valuer determines that there are no substantive differences in any relevant attributes (for example, contractual terms, pattern, timing and amount of cash flows, issuer, and credit rating), the instruments could be considered identical. If so, the estimate of fair value would be based on the quoted price for the identical instrument, unadjusted (a Level 1 estimate).
- b. If the valuer determines that the instruments are identical with respect to some but not all relevant attributes, the instruments could be considered similar. If so, and the price effect of the difference (in the amount of aggregate cash flows) is objectively determinable, the estimate of fair value would be based on the quoted price for the similar instrument, adjusted as appropriate for the difference (a Level 2 estimate).
- c. Even if the valuer determines that the instruments differ with respect to many relevant attributes, the instruments might be comparable. For example, the instruments might fall within the same general class (or subset of a class) of financial instruments such that the cash flows (prices) would be expected to similarly respond to changes in market conditions, but the price effect of the differences in the aggregate is not objectively determinable making the related adjustments necessarily subjective. In that case, the estimate of fair value would be based on the quoted price for the comparable instrument, adjusted as appropriate for the differences, and considered together with the results of other applicable valuation techniques (a Level 3 estimate).

Level 1 Reference Market

Example 5

B9. The Level 1 reference market is the active market to which an entity has immediate access or, if the entity has immediate access to multiple active markets with different prices, the most advantageous market. Selection of the appropriate reference market is

²⁰Other pronouncements provide related guidance for certain types of assets and liabilities, including FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (paragraph 48), and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (paragraph 21(a)(1)).

important because a Level 1 estimate is based solely on the quoted price in that market. Example 5 illustrates the selection of the appropriate Level 1 reference market for assets with quoted prices in multiple active markets.

- a. An entity holds assets that are traded in multiple active markets with different prices depending on whether they are traded individually (Markets A and B) or in a portfolio together with other similar assets (Market C). If the entity's assets do not make up a portfolio that could be traded in Market C, the entity would have immediate access to Markets A and B but not Market C. Conversely, if the entity's assets make up a portfolio that could be traded in Market C and the entity has previously demonstrated the ability to access that market, the entity also would have immediate access to Market C.
- b. If the entity has access to Markets A and B but not Market C (because the entity's assets do not make up a portfolio that could be traded in Market C), the Level 1 reference market would depend on which of those markets (Market A or B) is most advantageous. The price in Market A is \$25, and costs to transact in that market are \$5 (the net amount that would be received for the asset in that market is \$20). The price in Market B is \$35, and costs to transact in that market are \$20 (the net amount that would be received for the asset in that market is \$15). In that case, the most advantageous market is Market A. The estimate of fair value would be determined using the price in Market A (\$25). That price would not be adjusted for costs to transact in that market.

Application of Multiple Valuation Techniques

B10. Level 3 estimates require varying degrees of judgment in the selection and application of valuation techniques and inputs. Because each valuation is unique, the judgments applied will differ. Examples 6–8 illustrate, in qualitative terms, the kinds of judgments that might be applied in developing those estimates.

Example 6

B11. Example 6 considers a Level 3 estimate for machinery that is used in income-producing activities of an entity. The valuer estimates the fair value of the machinery using a market and cost approach (assuming an in-use valuation premise). The valuer decides not to use an income approach because the machinery does not have a separately identifiable income stream. Information about short-term and intermediate-term lease rates for similar used machinery sufficient to project an income stream (lease payments over remaining service lives) is available. However, because the income stream is to the lessor, the valuer would need to adjust the income stream for elements specific to the lessor that would not enter into an exchange price, for example, financing, replacement guarantees, and maintenance. Because such adjustments are necessarily subjective and other relevant market inputs are available, the valuer determines that for the machinery being measured, an income approach would not provide significant additional information relative to a market and cost approach.

B12. The valuer applies a market approach using quoted prices for recent sales of used machinery and a cost approach using quoted prices for new machinery. In both cases, the prices are adjusted as appropriate for differences (condition and location of the asset and, with respect to the transactions considered in the market approach, the timing of those transactions). The market approach estimate ranges from \$42,000 to \$48,000. The cost approach estimate ranges from \$40,000 to \$50,000. The valuer determines that the market approach estimate provides a representative estimate of fair value. The market inputs used in that approach (quoted prices for used machinery) are more relevant and reliable than those used in the cost approach (quoted prices for new machinery) because they require fewer and less subjective adjustments for differences. Also, there are no known unexplained differences. The valuer determines that no one point in the range indicated by the market approach is a better indicator of fair value than another. Because a point estimate of fair value is required, the valuer estimates fair value using the midpoint of the range (\$45,000).

Example 7

B13. Example 7 considers a Level 3 estimate for an income-producing software asset developed by a company (for sale to customers) recently acquired in a business combination. The valuer estimates the fair value of the software asset using an income and cost approach. The valuer is not able to use a market approach because information about market transactions for similar software assets is not released publicly.

B14. The valuer applies an income approach using a present value technique. The cash flows used in that technique reflect the income stream expected to result from sales of the software asset (to customers) over its economic life. The income approach estimate is \$15 million. In contrast, the cost approach estimate is \$1 million. The valuer acknowledges that a willing buyer that is able to replicate an identical software asset for \$1 million would not pay \$15 million to otherwise acquire it in an exchange transaction. However, the valuer determines that the cost approach estimate does not consider all of the costs necessary to replace the software asset. Specifically, the estimate does not consider certain indirect development costs. The valuer could extend the cost approach to consider those costs but decides not to because those costs are highly speculative. For the particular software asset being measured, the valuer determines that considering such costs would not necessarily improve the reliability or the relevance of the cost approach estimate relative to the income approach estimate. Accordingly, the estimate of fair value is \$15 million.

Example 8

B15. Example 8 considers a Level 3 estimate for a non-income-producing software asset developed by a company for internal use (to track and analyze its customer purchases) recently acquired in a business combination. The valuer estimates the fair value of the software asset using an income and cost approach. The valuer is not able to use a market approach because information about market transactions for similar software assets is not released publicly.

B16. The valuer applies an income approach using a present value technique. The cash flows used in that technique reflect the incremental profits to the company expected to result from efficiencies resulting from the use of the software asset over its economic life. The income approach estimate is \$3 million. In contrast, the cost approach estimate is \$1.5 million. The valuer determines that the cost approach estimate considers all of the costs necessary to replace the software asset and, absent reliability concerns, is more relevant than the income approach estimate. A willing buyer that is able to replicate an identical software asset for \$1.5 million would not pay \$3 million to acquire it in an exchange transaction. Accordingly, the estimate of fair value is \$1.5 million.

Restricted Securities

B17. Restricted securities are securities for which sale is legally restricted by governmental or contractual requirement for a specified period. Restricted securities are often purchased at a discount from the quoted price of otherwise identical unrestricted securities, reflecting the lack of liquidity relating to the inability to access that market for the specified period. Therefore, in estimating the fair value of restricted securities, the quoted price of an otherwise identical unrestricted security shall be adjusted for the effect of the restriction, considering factors such as the nature and duration of the restriction, the volatility of the unrestricted security, and the risk-free interest rate.²¹

B18. Determining the discount amount requires judgment. Related guidance in SEC ASR No. 113, *Statement Regarding "Restricted Securities,"* incorporated in this Statement, follows:

- a. The valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper.
- b. The continued valuation of restricted securities at cost would be improper if, as a result of the operations of the issuer or change in general market conditions or otherwise, cost has ceased to represent fair value.
- c. The valuation of restricted securities by applying either a constant percentage or an absolute dollar discount to the market quotations for otherwise identical unrestricted securities would be improper. Thus, it would be improper to maintain the same percentage discount (from the market quotation for otherwise identical unrestricted securities) that was received when the restricted securities were purchased, without regard to other relevant factors such as, for example, the extent to which the inherent value of the securities may have changed.
- d. The valuation of restricted securities by reference to the market price for otherwise identical unrestricted securities assumes that the market price for the unrestricted securities is representative of the fair value of the restricted securities. This may not be the case when the market for the unrestricted securities is very thin (that is, if only a limited volume of shares are available for trading). With a thin market, the news of the company's purchase of the restricted securities may, by itself, stimulate

²¹The guidance in this Statement applies to restricted securities covered under other pronouncements, including equity securities with restrictions that terminate within one year, which are included in the scope of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

a public demand for the unrestricted securities, the supply of which has not been increased, and thus lead to an increase in the valuation of both the restricted securities and unrestricted securities.

- e. If in valuing restricted securities, the diminution in value attributable to the restrictive feature is itself affected by factors subject to change, such as the length of time that must elapse before the company may require the issuer to cause the securities to be registered for public sale, the valuation should reflect any such changes.
- f. Some companies value restricted securities, acquired at prices below the market quotations for otherwise identical unrestricted securities, by amortizing the difference over some chosen period on the assumption that it will be possible to sell them at the market price for unrestricted securities at the expiration of the time period. Under prevailing conditions, however, it cannot always be determined either that the securities will, in fact, be effectively registered at the expiration of that period or that their public sale will otherwise be possible. For example, the issuer may be unable or unwilling to register at the expiration of the estimated period, and public sale at the end of that period without registration may not be lawful. Consequently, the practice of amortizing the discount over an arbitrarily chosen period creates the appearance of an appreciation in the value of the securities which has not, in fact, occurred, and, accordingly, is improper.

B19. In summary, no automatic formula exists by which a company can estimate the fair value of restricted securities. A company shall determine the method for estimating the fair value of restricted securities and continually review the appropriateness of that method.

Fair Value Disclosures

B20. This Statement requires disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. The disclosures apply to assets and liabilities that are remeasured at fair value during the period, whether on a recurring (or ongoing) basis (for example, trading securities) or on a nonrecurring (or periodic) basis (for example, impaired long-lived assets). The objective of the disclosures is to provide, in one place, information about the extent to which fair value is used to remeasure assets and liabilities, incorporating the similar information disclosed under other pronouncements.

B21. Other assets and liabilities may be remeasured at amounts that are not fair value but that, like fair value, represent current amounts (for example, inventories that are written down to market value under ARB No. 43, Chapter 4, "Inventory Pricing"). This Statement encourages disclosures about those other remeasurements as part of the fair value disclosures required by this Statement.

B22. The following table illustrates how the disclosures for assets that are remeasured at fair value on a recurring (or ongoing) basis during the period might be presented. A similar table also could be presented for liabilities.

ASSETS							
<u>Description</u>	<u>Fair Value Amount</u>	<u>Quoted Prices</u>		<u>Valuation Models</u>		<u>Unrealized Gains or Losses</u>	
		<u>Identical Items</u>	<u>Similar Items</u>	<u>Significant Market Inputs</u>	<u>Significant Entity Inputs</u>	<u>Earnings</u>	<u>OCI</u>
Trading securities	\$ 80	\$ 75	\$ 5			\$ 15	
Available-for-sale securities	60	60					\$ (10)
Derivatives	70		20	\$ 40	\$ 10	3	2
Venture capital investments	5				5		
Long-lived asset held for sale	<u>120</u>	<u>120</u>				<u>(45)</u>	
Total	<u>\$ 335</u>	<u>\$ 255</u>	<u>\$ 25</u>	<u>\$ 40</u>	<u>\$ 15</u>	<u>\$ (27)</u>	<u>\$ (8)</u>
% of total assets at 12/31/XX					<u>15%</u>		

B23. The following illustrates how the disclosures for assets that are remeasured at fair value on a nonrecurring (or periodic) basis during the period might be presented.

In accordance with the provisions of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, long-lived assets held and used with a carrying amount of \$100 million were written down to their fair value of \$75 million, resulting in an impairment loss of \$25 million. Those assets represent 40 percent of total long-lived assets at 12/31/XX. Fair value was determined using quoted prices for similar long-lived assets, adjusted as appropriate for differences. (Refer to Footnote Y.)

Also, in accordance with the provisions of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, goodwill with a carrying amount of \$65 million was written down to its implied fair value of \$30 million, resulting in an additional impairment loss of \$35 million. Fair value was determined using valuation techniques consistent with a market approach (prices for comparable market transactions) and present value techniques incorporating significant market inputs. (Refer to Footnote Z.)

Appendix C

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEWS

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Appendix C

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEWS

Introduction

C1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes the reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

C2. In many pronouncements, the Board has concluded that fair value information is relevant. That information is useful to present and potential investors, creditors, and others in making rational investment, credit, and similar decisions—the first objective of financial reporting in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*. Conceptually, fair value is a market-based measurement that is not affected by factors specific to a particular entity. Accordingly, it represents an unbiased measurement that is consistent from period to period and across entities.

C3. Users of financial statements generally have agreed that fair value information is relevant. However, others have expressed concerns about the ability to apply the fair value measurement objective in generally accepted accounting principles (GAAP), focusing on the reliability of the measurement in the absence of quoted market prices. Reliability encompasses neutrality, verifiability, and representational faithfulness and is not intended to denote certainty or precision. More recently, in response to the FASB Proposal, *Principles-Based Approach to U.S. Standard Setting*, issued in October 2002,²² many respondents generally agreed on the need for standards that emphasize principles (over detailed rules) but raised concerns about the ability to develop principles that would be generally understood and consistently applied within the existing conceptual framework. In that regard, many respondents referred to measurement principles in general (focusing on the mixed attribute model that currently exists) and fair value measurements in particular, noting the increased use of those measurements in existing and proposed standards.

C4. The Board believes that in large part, those concerns result because there is limited guidance for applying the fair value measurement objective in GAAP. The guidance that currently exists has evolved “piecemeal” over time and is dispersed among the many pronouncements that require fair value measurements. Differences in that guidance have created inconsistencies that have added to the complexity in GAAP. There also is limited

²²In July 2003, the Securities and Exchange Commission (SEC) published the SEC Staff’s “Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System,” which encouraged a move to more “objectives-oriented” accounting standards.

conceptual guidance for addressing measurement issues in the Board's conceptual framework. For example, FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, developed nearly 20 years ago, does not identify fair value as a possible measurement attribute. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, developed more recently, in 2000, discusses fair value measurements, but in the context of present value techniques.

C5. More broadly, the Concepts Statements acknowledge that neither relevance nor reliability is the paramount characteristic of accounting information and that the two must be balanced against one another. However, the Concepts Statements do not provide an adequate basis for determining how the characteristics of relevance and reliability should be applied, and trade-offs considered, in selecting an appropriate measurement attribute, whether or not that attribute is fair value.

Financial Instruments Project

C6. Prior to this Statement, the Board addressed issues related to fair value, but to varying degrees and largely in the context of financial instruments. Specifically, in 1986, the Board added a broad financial instruments project to its agenda to address issues for financial instruments that were arising, or that were given a new sense of urgency, as a result of financial innovation. Because the issues were complex and pressing, the Board decided to address them in phases through different but related projects. Those projects resulted in issuance of several FASB Statements, including FASB Statements No. 107, *Disclosures about Fair Value of Financial Instruments*, in 1991, and No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in 1998.

C7. In developing those Statements, the Board concluded that fair value is the most relevant measure for financial instruments and established a long-term objective of measuring all financial instruments at fair value. In 1997, the Board added a separate financial instruments project to its agenda to resolve issues impeding its efforts to achieve that objective. Paragraphs 333 and 334 of Statement 133 explain:

The Board believes changing the accounting model so that all financial instruments are measured at fair value in the statement of financial position is the superior conceptual solution to hedging issues. However, the Board decided that it was not appropriate at this time to require fair value measurement for all financial instruments. Board members decided that they must first deliberate and reach agreement on conceptual and practical issues related to the valuation of certain financial instruments, including liabilities, and portfolios of financial instruments. The Board is pursuing issues related to fair value measurement of all financial assets and liabilities in a separate project.

The Board is committed to work diligently toward resolving, in a timely manner, the conceptual and practical issues related to determining the fair values of financial instruments and portfolios of financial instruments. Techniques for refining the measurement of the fair values of

all financial instruments continue to develop at a rapid pace, and the Board believes that all financial instruments should be carried in the statement of financial position at fair value when the conceptual and measurement issues are resolved.

C8. In 1999, as part of its separate financial instruments project, the Board issued FASB Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*.²³ The Preliminary Views set out the Board's views on three core issues: (a) what should be reported at fair value, (b) what is fair value, and (c) how changes in fair value should be reported.²⁴ Many respondents generally supported an objective of measuring financial instruments at fair value but raised concerns that indicated the need for additional work, particularly in the area of measurement, before moving to a full fair value model for all financial instruments.

C9. In response, in 2001, the Board decided to change the focus of its separate financial instruments project. Specifically, the Board decided to defer consideration of what should be reported at fair value and, as an interim step, improve the fair value measurement guidance (and related disclosures) in Statement 107 for financial instruments. Paragraph 313 of Statement 133 states:

This Statement refers to Statement 107 for guidance in applying the definition of fair value. Some respondents to the Exposure Draft asked either for additional guidance on estimating the fair value of financial instruments or for amendments of part of the guidance in Statement 107. They said that the guidance in Statement 107 is not robust enough for recognition purposes (as opposed to disclosure) and allows too much variability in the estimates of fair value, especially for items not traded on a public exchange. The Board decided for several reasons to retain the guidance provided by Statement 107. Statement 107 has been in effect for several years, and entities are familiar with its measurement guidance. In addition, Board members were concerned that reevaluating and making the fair value guidance more prescriptive would significantly delay issuance of this Statement. On balance, the Board decided that the measurement guidance in Statement 107 is sufficient for use in applying this Statement. The Board will consider measurement issues and likely provide additional guidance or change Statement 107's guidance in some areas, perhaps including the areas discussed in the following paragraphs in the course of its project on the fair value measurement of financial instruments.

²³Subsequently, the Financial Instruments Joint Working Group of standard setters, an ad hoc group consisting of the FASB and standard setters from other countries, was formed to develop a proposed standard on accounting for financial instruments. Its proposed standard was published in the FASB Special Report, *Financial Instruments and Similar Items*, in 2000.

²⁴In this Statement, the Board reconsidered certain aspects of the Preliminary Views related to fair value measurements of financial instruments.

Fair Value Measurement Project

C10. Subsequently, in other agenda projects with proposed fair value measurement requirements (including the business combinations project), the Board identified measurement issues for nonfinancial assets and liabilities that, in many respects, were similar to those previously identified for financial instruments. In June 2003, the Board added this fair value measurement project to its agenda to address those issues for all assets and liabilities and removed the separate financial instruments project from its agenda. The Board agreed that, conceptually, the fair value measurement objective and the approach for applying that objective should be the same for all assets and liabilities and that addressing fair value measurement issues for financial instruments separate from other assets and liabilities, in different projects, could create differences that would perpetuate the complexity in GAAP. The Board remains committed to achieving its long-term objective of measuring all financial instruments at fair value, but not until all related issues are resolved.

C11. The Board's near-term objective is to develop a Statement that clarifies the fair value measurement objective and its application in GAAP. This Statement achieves that initial (Phase 1) objective. Specifically, this Statement establishes a framework that builds on current practice and requirements, clarifying the fair value measurement objective and its application under other pronouncements that require fair value measurements (refer to Appendix E). The fair value framework simplifies and, where appropriate, codifies the similar guidance in those pronouncements and applies broadly to financial and nonfinancial assets and liabilities.

C12. This Statement does not establish requirements for when to measure assets and liabilities at fair value. The Board expects to consider that issue on a project-by-project basis in individual pronouncements. In that regard, the Board's longer-term objective is to improve its conceptual framework, developing conceptual guidance for its use in establishing requirements for when to measure fair value that will focus on the qualitative characteristics of relevance and reliability and related trade-offs. The Board expects to address those conceptual issues in a subsequent phase of this project.

C13. In 2003, the Board formed the Valuation Resource Group (VRG), made up of preparers, auditors, and valuation specialists, to provide a standing resource to the Board and staff on fair value measurement issues. In developing this Statement, members of the Board and staff consulted with the VRG, as well as the Financial Accounting Standards Advisory Council (FASAC), the User Advisory Council (UAC), and other interested parties.

Scope

Phase 1 Scope Exclusions

C14. In Phase 1, the Board decided to address fair value measurement issues broadly. Of the existing pronouncements that require fair value measurements, the Board decided to exclude from the Phase 1 scope pronouncements that require a fair value measurement

using a measurement objective that differs from the fair value measurement objective in this Statement and pronouncements that include guidance for applying a fair value measurement objective that, while similar, raises issues specific to the assets and liabilities covered under those pronouncements. Those scope exclusions relate to (a) revenue recognition transactions measured using vendor-specific objective evidence (VSOE) of fair value (based largely on the guidance in AICPA Statement of Position 97-2, *Software Revenue Recognition*, and EITF Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables”), (b) share-based payment transactions, and (c) leasing transactions. The Board is addressing fair value measurement issues specific to revenue recognition and share-based payment transactions in other projects. The fair value measurement objective under consideration in those projects is generally consistent with the fair value measurement objective and related guidance in this Statement. Accordingly, the Board expects to eliminate those scope exceptions upon issuance of final Statements in those projects. With respect to leasing transactions, the Board expects to consider at a future date whether to address fair value measurement issues specific to those transactions in a separate project or in a subsequent phase of the fair value measurement project.

C15. In its discussions, the Board considered similar measurements required under other pronouncements, in particular, APB Opinion No. 21, *Interest on Receivables and Payables*, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and ARB No. 43, Chapter 4, “Inventory Pricing.”

C16. The Board clarified that in Opinion 21, the present value measurement objective for receivables and payables (notes) within the scope of that Opinion is fair value. The discount rate for contractual cash flows described in Opinion 21 (rate commensurate with the risk) embodies the same notion as the discount rate used in the discount rate adjustment technique described in Appendix A. Paragraph 13 of Opinion 21 explains:

The objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity.

C17. Accordingly, the guidance for using present value techniques in this Statement applies for the present value measurements required under Opinion 21. It also applies for the similar present value measurements required under other pronouncements, including FASB Statements No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, No. 63, *Financial Reporting by Broadcasters*, No. 87, *Employers’ Accounting for Pensions*, and No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*.

C18. The Board clarified that in Statement 114 the present value measurement objective for impaired loans within the scope of that Statement is not fair value, although a fair value measurement results if an observable market price (or fair value of collateral) is used as a practical expedient. Accordingly, Statement 114 is excluded from the Phase 1

scope. The Board similarly clarified that in ARB 43, Chapter 4 the “market value” measurement resulting from the application of the lower of cost or market measurement required for inventories is not fair value. It places upper and lower limits on the measurement that may not result in a fair value measurement. ARB 43, Chapter 4 and other pronouncements that require a similar lower of cost or market measurement also are excluded from the Phase 1 scope. However, this Statement encourages but does not require disclosures about those (and other) similar remeasurements that, like fair value, represent current amounts.

Practicability Exceptions to Fair Value

C19. Some pronouncements within the Phase 1 scope permit “practicability exceptions” to fair value measurements in specified circumstances. With respect to financial instruments, the Board observed that some of those practicability exceptions create inconsistencies in the requirement for Level 3 estimates using significant entity inputs.

C20. For example, Statement 107 permits a practicability exception to the fair value measurements required under that Statement. Paragraph 15 of Statement 107 explains:

In the context of this Statement, *practicable* means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

C21. In contrast, Statement 133 prohibits the practicability exception in Statement 107. Paragraph 318 of Statement 133 explains:

Statement 107 requires disclosure of the fair value of financial instruments “for which it is *practicable* to estimate that value” (emphasis added). Unlike Statement 107, this Statement provides no *practicability* exception that would permit an entity to avoid the required fair value measurements. The Board believes that prudent risk management generally would require an entity to measure the fair value of any derivative that it holds as well as any item (or the portion of the item

attributable to the identified risk) designated as being hedged in a fair value hedge.

C22. In this Statement, the Board decided not to reconsider those (or other) practicability exceptions. The Board concluded that they raise issues about what to measure at fair value that are beyond the scope of this project. Also, in large part, those issues result from concerns about the reliability of fair value measurements, which the Board expects to address more broadly in the conceptual phase of this project.

C23. For similar reasons, the Board decided not to address issues relating to 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.” Issue 02-3 precludes recognition of an unrealized gain or loss at inception of a derivative instrument if the fair value estimate is, in effect, a Level 3 estimate using significant entity inputs. Issue 02-3 does not address similar issues in periods subsequent to inception. The Board is addressing related issues in its revenue recognition project.

Definition of Fair Value

C24. As a basis for developing the fair value framework, the Board decided to clarify the definition of fair value. The definition emphasizes the exchange price notion contained, either explicitly or implicitly, in the definitions of fair value previously included in many pronouncements within the Phase 1 scope. The exchange price is an estimate based on the actions of marketplace participants in a “hypothetical” exchange transaction motivated by normal business considerations. The Board clarified that in the absence of an actual transaction for the asset or liability being measured, a hypothetical exchange transaction notion is essential as a basis for replicating an exchange price for that asset or liability.

C25. The general concept of marketplace participants is discussed in paragraph 26 of Concepts Statement 7, which states:

Among their many functions, markets are systems that transmit information in the form of prices. Marketplace participants attribute prices to assets and, in doing so, distinguish the risks and rewards of one asset from those of another. Stated differently, the market’s pricing mechanism ensures that unlike things do not appear alike and that like things do not appear to be different (a qualitative characteristic of accounting information). An observed market price encompasses the consensus view of all marketplace participants about an asset or liability’s utility, future cash flows, the uncertainty surrounding those cash flows, and the amount that marketplace participants demand for bearing those uncertainties.

This Statement incorporates and clarifies that concept of marketplace participants in the context of the willing buyers and sellers referred to in the definition of fair value.

C26. The Board affirmed that the exchange price used to estimate fair value should not be adjusted for transaction costs that, like cost to sell in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, include “the incremental

direct costs to transact a sale, that is, the costs that result directly from and are essential to a sales transaction and that would not have been incurred by the entity had the decision to sell not been made” (paragraph 35). This Statement does not specify the accounting for transaction costs. Such costs should be accounted for in accordance with the provisions of other applicable pronouncements (generally, in the period incurred).

Interaction between Fair Value and Fair Market Value

C27. Through input received from constituents, the Board learned that the definition of fair value used for financial reporting purposes often is confused with the similar definitions of fair market value used for valuation purposes. Specifically, Internal Revenue Service Revenue Ruling 59-60 defines fair market value as “the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.” That definition of fair market value represents the legal standard of value in many valuation situations. Because the definitions of fair market value and fair value are similar, both emphasizing the need to consider the actions of marketplace participants (willing buyers and sellers) in the context of a hypothetical exchange transaction, some constituents asked the Board whether, in its view, they are the same or different. The Board believes that the measurement objectives embodied in the definitions are essentially the same. However, the Board observed that the definition of fair market value has a significant body of interpretive case law, developed in the context of tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, the Board chose not to simply adopt the definition of fair market value, and its interpretive case law, for financial reporting purposes.

Unit of Account

C28. The unit of account defines the boundaries of what is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated), that is, whether individually or as part of a larger group of assets (and liabilities). In developing this Statement, the Board observed that because many assets and liabilities are exchanged in different markets with different prices depending on the level at which they are aggregated (or disaggregated), the unit of account for an individual asset or liability can have a significant effect on the estimate of fair value. The Board believes that a unit-of-account principle is needed for its use in developing pronouncements, in particular, those with fair value measurement requirements. However, because related issues are pervasive, having implications for recognition and display generally, the Board decided not to address those issues in this initial phase of the project, except as discussed below (for certain financial instruments). Instead, the Board agreed that those issues should be separately addressed, preferably at the concepts level. The Board noted that many pronouncements within the Phase 1 scope specify, explicitly or implicitly, the unit of account that should be used for the fair value measurements required under those pronouncements. The Board decided that the unit-of-account guidance in those pronouncements should remain unchanged until such time as it fully considers all related issues.

Measurement of Blocks

C29. For unrestricted securities with quoted prices in active markets (for identical securities), other pronouncements (including Statements 107 and 133) require that fair value be estimated as the product of the quoted price times the quantity held. In those cases, the unit of account is the individual trading unit. In contrast, for large positions (blocks) of such securities held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries (Guides) permit fair value to be estimated using blockage factors (adjustments to quoted prices) in limited circumstances, based on an assessment of various factors, including the size of the positions held and liquidity of the market. In those cases, the unit of account is a block.

C30. The Board decided to address that inconsistency as it relates to broker-dealers and certain investment companies in its separate financial instruments project. Specifically, in the Preliminary Views, the Board proposed to prohibit the use of blockage factors, affirming its similar decisions in other existing pronouncements.

C31. Paragraph 58 of Statement 107 explains:

Although many respondents to the 1990 and 1987 Exposure Drafts agreed with the usefulness of disclosing quoted market prices derived from active markets, some argued that quoted prices from thin markets do not provide relevant measures of fair value particularly when an entity holds a large amount of a thinly traded financial instrument that could not be absorbed by the market in a single transaction. The Board considered this issue and reiterated its belief that quoted prices, even from thin markets, provide useful information because investors and creditors regularly rely on those prices to make their decisions. The Board noted that providing the liquidation value of a block of financial instruments is not the objective of this Statement. The Board also concluded that requiring the use of available quoted market prices would increase the comparability of the disclosures among entities.

C32. Paragraph 315 of Statement 133 further explains:

Consistent with Statement 107, the definition of fair value in this Statement precludes an entity from using a “blockage” factor (that is, a premium or discount based on the relative size of the position held, such as a large proportion of the total trading units of an instrument) in determining the fair value of a large block of financial instruments. The definition of fair value requires that fair value be determined as the product of the number of trading units of an asset times a quoted market price if available [as required by Statement 107]. . . . Some respondents to the Exposure Draft indicated that the guidance in Statement 107 (and implicitly the definition of *fair value* in this Statement) should be revised to require or permit consideration of a discount in valuing a large asset position. They asserted that an entity that holds a relatively large amount (compared with

average trading volume) of a traded asset and liquidates the entire amount at one time likely would receive an amount less than the quoted market price. Although respondents generally focused on a discount, holding a relatively large amount of an asset might sometimes result in a premium over the market price for a single trading unit. The Board currently believes that the use of a blockage factor would lessen the reliability and comparability of reported estimates of fair value.

C33. Respondents to the Preliminary Views and others raised concerns about blockage factors. One group, including broker-dealers, reiterated earlier concerns (in Statements 107 and 133) about prohibiting the use of blockage factors. They said that for blocks, prohibiting the use of blockage factors would diminish the relevance of the resulting fair value measurements. They indicated that because block traders transact in the block market, fair value measurements determined using quoted prices, without adjustment for blockage factors, would not faithfully reflect the entity's business activities. Moreover, to the extent a block is purchased at a discount to the quoted price, the entity would be required to record an immediate (unrealized) gain that may never be realized. In contrast, others expressed concerns about permitting the use of blockage factors. They indicated that the use of blockage factors would diminish the reliability of the resulting fair value measurements. In that regard, they referred to diversity in practice among entities in determining when to use blockage factors (in particular, how to define "blocks") and how to measure blockage amounts.

C34. In response, in 2000, the AICPA Accounting Standards Executive Committee (AcSEC) formed a Blockage Factor Task Force (Task Force) to address the use of blockage factors by broker-dealers and certain investment companies, focusing on block discounts (versus premiums). Based on its meetings with industry representatives (broker-dealers, mutual funds, and other investment companies) and review of relevant academic research and market data, the Task Force affirmed that discounts involving "large" blocks exist, generally increasing as the size of the block to be traded (expressed as a percentage of the daily trading volume) increases, but that the methods for determining when and how to measure the discount amounts are largely subjective.

C35. In 2002, after meeting with representatives of the Task Force at a public meeting to discuss the project, the Board undertook initiatives to realign the roles of U.S. standard setters (including AcSEC). In connection with those initiatives, the Board decided to reconsider the use of blockage factors by broker-dealers and investment companies in this project. The Board acknowledged its earlier view in Statement 107 (and other pronouncements) on the use of quoted prices in active markets. However, the Board concluded that for blocks, the threshold issue is not whether the measurement should be determined using quoted prices in active markets. Rather, it is one of determining the appropriate unit of account for the measurement, that is, whether the measurement should be based on an individual trading unit (requiring the use of quoted prices) or a block (permitting the use of blockage factors).

C36. With respect to that unit-of-account issue, the Board observed that if it were to prohibit the use of blockage factors, the fair value of blocks of securities that are made up

of individual units that trade in an active market would always be determined as the product of the quoted price of an individual trading unit times the quantity of that trading unit held. This would be so even where, as part of its regular and ongoing business activities, an entity (broker-dealer) both buys and sells securities in blocks. In circumstances in which securities are both bought and sold as part of an enterprise's regular activities, the Board agreed that valuing such positions using the price of an individual trading unit could result in financial reporting that would not be representationally faithful of the underlying business activities. Further, it could result in distorted and misleading reporting by, for example, giving the appearance of an instant gain upon buying a block, only to be followed by a reported loss on subsequently selling the block.

C37. In response, the Board considered various ways to approach the measurement of blocks (using blockage factors). One approach considered factors specific to each position, including the relationship between the market capitalization of the company in which the equity investment is held and the size of the block to be traded, expressed as a percentage of the daily volume. Another approach considered an entity's intent to transact in the block market, whereby an entity would, for example, designate its intent with regard to each block held and apply a discount to those designated blocks. Yet another approach considered facts and circumstances providing evidence of an entity's intent to transact in the block market, including a demonstrated history of buying and selling blocks.

C38. However, the Board was unable to define the unit of account for a block or otherwise establish a threshold criterion for determining when a block exists (and subsequently ceases to exist) as a basis for determining when to use a blockage factor. The Board agreed that for blocks, the definitional issues, taken together with the lack of a generally accepted approach for measuring blockage amounts, are significant. For that reason, the Board agreed that those issues should be separately considered together with other unit-of-account issues. The Board decided that for measurement of blocks held by broker-dealers and certain investment companies, current practice as permitted under the Guides should remain unchanged until such time as the Board fully considers those issues.

Present Value Techniques

C39. Concepts Statement 7 provides conceptual guidance for using present value techniques for fair value measurements—an expected cash flow approach and a traditional approach. Through input received from constituents, the Board learned that questions have been raised about the application of those techniques, in particular, an expected cash flow approach. The Board decided to address those questions and include the present value guidance in Concepts Statement 7, as updated in this Statement, thereby elevating that guidance to Level A GAAP (refer to Appendix A).²⁵ This Statement does not amend

²⁵To describe the present value techniques in Concepts Statement 7 more clearly, this Statement refers to the expected cash flow approach as an expected present value technique and to the traditional approach as a discount rate adjustment technique. The application of those techniques to liabilities is brought forward in this Statement, substantially unchanged.

Concepts Statement 7. The Board expects to consider the need for amendments to Concepts Statement 7 in the conceptual phase of this project.

C40. With respect to the expected cash flow approach, some constituents pointed out that Concepts Statement 7 refers to the appropriate discount rate for expected cash flows as the risk-free interest rate. They said that the emphasis on the risk-free interest rate could be interpreted as requiring that the adjustment for risk (systematic or nondiversifiable) be reflected only in the expected cash flows. In contrast, in many valuation situations, the adjustment for risk is reflected in the discount rate, that is, as an adjustment to the risk-free interest rate (as is the case when applying the traditional approach). Those constituents asked the Board to clarify whether it was its intent in Concepts Statement 7 to preclude that alternative, which would result in a significant change to valuation practice. The Board clarified that it was not its intent to preclude that alternative. To convey its intent more clearly, the Board expanded the guidance in Concepts Statement 7 to clarify that when using expected cash flows, the adjustment for risk may be reflected in either the expected cash flows (Method 1) or the discount rate (Method 2). Further, the risk-free interest rate is the appropriate discount rate only if the adjustment for risk is reflected in the expected cash flows.

C41. In its discussions, the Board reconsidered the guidance in paragraph 68 of Concepts Statement 7, which states, “An entity typically will be able to estimate the expected cash flows from an asset or liability, but the appropriate risk premium consistent with fair value may be difficult to determine.” The Board observed that paragraph 68 could be interpreted as allowing a default of no risk adjustment in situations in which it is “difficult” to determine the appropriate risk adjustment. The Board affirmed its conclusion in Concepts Statement 7 that risk is an essential element of any present value technique and that “excluding a risk adjustment (if it is apparent that marketplace participants include one) would not produce a measurement that faithfully represents fair value” (paragraph 62). The Board decided that the degree of difficulty in determining the appropriate risk adjustment, alone, is not sufficient basis on which to allow a default of no risk adjustment.

Other Valuation Techniques

C42. Some constituents pointed out that in many pronouncements within the Phase 1 scope, the fair value measurement guidance could be interpreted as emphasizing present value techniques to the exclusion of other valuation techniques. They said that present value techniques, while useful and relevant in many valuation situations, apply only one valuation approach, the income approach. In contrast, generally accepted valuation practices (for example, under the Appraisal Foundation’s Uniform Standards of Professional Appraisal Practice) require that a valuation specialist consider valuation techniques that, in addition to an income approach, apply the market and cost approaches. Accordingly, if present value techniques are used, it is common for the results of those techniques to be compared and corroborated through the results of valuation techniques that apply other valuation approaches. In response, the Board clarified that it does not intend to preclude or otherwise limit the valuation techniques used for fair value measurements. Consistent with generally accepted valuation practices, this Statement

emphasizes the need to consider valuation techniques that apply the market, income, and cost approaches, especially for Level 3 estimates.

Fair Value Hierarchy

C43. Other pronouncements within the Phase 1 scope refer, explicitly or implicitly, to the need to consider the assumptions and data that marketplace participants would use in all estimates of fair value. This Statement incorporates and clarifies that concept broadly in the context of market inputs. The Board acknowledges that selecting and using relevant inputs requires judgment. As a basis for applying that judgment, this Statement establishes a hierarchy that groups into three broad categories (levels) the inputs that should be used for all estimates of fair value, considering the relative reliability of the resulting estimates. In general, the more market inputs, the more reliable the estimate. Accordingly, the fair value hierarchy gives the highest priority to market inputs that reflect quoted prices in active markets and the lowest priority to entity inputs that reflect an entity's own internal estimates and assumptions.

Level 1 Estimates

C44. Level 1 requires the use of quoted prices for *identical* assets or liabilities in active markets (an application of the market approach). The Board affirmed that quoted prices in active markets provide the most reliable estimate of fair value and should be used whenever they are available for the asset or liability being measured. Paragraph 57 of Statement 107 explains:

The Board concluded that quoted market prices provide the most reliable measure of fair value. Quoted market prices are easy to obtain and are reliable and verifiable. They are used and relied upon regularly and are well understood by investors, creditors, and other users of financial information. In recent years, new markets have developed and some existing markets have evolved from thin to active markets, thereby increasing the ready availability of reliable fair value information.

Level 1 Reference Market

C45. For a Level 1 estimate, a quoted price in an active market represents the sole market input. For that reason, and because an entity might have access to different markets having different prices for essentially the same asset or liability, the Board decided to incorporate a reference market notion requiring that an entity have immediate access to that market. The Board concluded that a less restrictive reference market notion requiring, for example, that an entity have reasonable access to that market, might be broadly interpreted, permitting entities discretion in selecting the price used for the estimate.

C46. In considering that issue further, the Board observed that for some assets and liabilities, an entity might have immediate access to multiple active markets with different prices (for example, financial instruments for which no single market represents a principal trading market). To achieve consistency, the Board clarified that for those assets and liabilities, the Level 1 reference market is the most advantageous market, that is, the

market with the price that would maximize the net amount that would be received for an asset and minimizes the net amount that would be incurred for a liability. The Board believes that a most advantageous market approach is reasonable based on the assumption that the ultimate goal of most entities is to maximize profits or net assets. It embodies both the buying and selling side of rational market behavior and is consistent with normal profit motivations.

Bid-Asked Spread Measurements

C47. In active dealer markets, bid and asked prices generally are more readily and regularly available than closing prices. The “bid” price represents the price the dealer is willing to pay. The “asked” price represents the amount at which the dealer is willing to sell. Generally, the difference represents dealer profit. Some pronouncements included within the Phase 1 scope require fair value estimates for financial instruments using bid and asked prices, but those pronouncements do not provide guidance on how to use those prices in developing the estimates.²⁶

C48. SEC ASR No. 118, *Accounting for Investment Securities by Registered Investment Companies*, provides related guidance, which is incorporated in the AICPA Audit and Accounting Guides for investment companies and broker-dealers. ASR 118 provides entities with flexibility in selecting the method to estimate fair value within a bid-asked spread, provided that the method is consistently applied. Accordingly, there is diversity in practice among entities in the methods used to develop those estimates. Methods generally appropriate include (a) bid prices for assets (and asked prices for liabilities), (b) average prices, determined using bid prices, bid and asked prices (mid-point price), and, for securities traded over the counter, a representative selection of broker-dealer quotes for a particular security, and (c) a valuation within the bid-asked spread considered best to represent value in the circumstances.

C49. Having clarified the fair value measurement objective and its exchange price notion, the Board considered whether to allow entities flexibility in applying that objective as currently permitted under ASR 118, specifying that the objective is to derive an exchange-equivalent price using bid and asked prices. The Board concluded that specifying the objective alone would not be sufficient. The methods used likely would continue to be different for different business activities (for example, market makers in securities). Instead, the Board decided to prescribe that method at the standards level to maximize consistency and comparability, focusing on Level 1 estimates (that is, bid and asked spreads created by firm offers to buy and sell in active dealer markets).

C50. Of the methods generally appropriate under ASR 118, the Board agreed that because a midpoint price averages multiple third-party dealer quotes, that method could derive an exchange-equivalent price, negotiated by reference to prices at either end of the spread. However, some constituents (broker-dealers) said that because dealers buy at or near the bid price and sell at or near the asked price, a midpoint price would result in an immediate

²⁶For example, FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*.

(unrealized) gain and subsequent loss (similar to concerns about prohibiting the use of blockage factors in measuring blocks). They said that for dealers, industry practice is to use bid prices for long positions (assets) and asked prices for short positions (liabilities).

C51. From a convergence standpoint, the Board noted that IAS 39 (revised), *Financial Instruments: Recognition and Measurement*, expresses a preference for the method referred to by those constituents. Paragraph BC99 of IAS 39 (revised) explains:

The Board confirmed the proposal in the Exposure Draft that the appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. It concluded that applying mid-market prices to an individual instrument is not appropriate because it would result in entities recognizing up-front gains or losses for the difference between the bid-ask price and the mid-market price.

C52. In view of related concerns and existing practice, the Board decided to adopt the approach in IAS 39 (revised), but without the permitted alternative. Specifically, the Board decided to require bid prices for long positions (assets) and asked prices for short positions (liabilities), but only for Level 1 estimates. In less active markets, the Board decided that other methods within the bid-asked spread should be considered (similar to other Level 3 estimates).

C53. The Board also considered related issues for a net open position raised by respondents to the Exposure Draft preceding IAS 39 (revised). For a net open position, the Board decided to adopt the approach in IAS 39 (revised). Paragraph BC100 of IAS 39 (revised) explains:

The Board discussed whether the bid-ask spread should be applied to the net open position of a portfolio containing offsetting market risk positions, or to each instrument in the portfolio. It noted the concerns raised by constituents that applying the bid-ask spread to the net open position better reflects the fair value of the risk retained in the portfolio. The Board concluded that for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence, may apply the bid or asking price to the net open position, as appropriate. The Board believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread.

Significant Events Occurring before End of Reporting Period

C54. The Board believes that entities should use all pricing information available at the end of a reporting period. However, the Board observed that in some cases in which significant events (for example, principal-to-principal or brokered trades or significant announcements) occur after the close of the market but before the end of the reporting

period, the closing price in that market might not be representative of fair value. The Board agreed that an entity need not go to great lengths to unearth information about after-hours trading but that an entity should not ignore any information that is available (for example, a large change in the price in another market after the close of the principal market in which the asset or liability trades). An awareness of changes is particularly important for instruments traded in foreign markets that close many hours before the normal end of the business day in the local area. The Board decided that entities should establish and consistently apply written policies on how to reflect significant events, if any, after the close of business but before the end of the reporting period but that entities should be allowed to use judgment in developing those policies (that is, in determining how those events affect fair value measurements).

Level 2 Estimates

C55. Level 2 requires the use of quoted prices for *similar* assets or liabilities in active markets, adjusted as appropriate for differences in cash flows and other factors relevant to the asset or liability being measured (an application of the market approach). For a Level 2 estimate, a quoted price in an active market, as adjusted, represents the sole market input. For that reason, the Board decided to require that the price effect of the differences that form the basis for the adjustments be objectively determinable, thereby limiting the use of those prices to situations in which different entities (“valuers”) likely would develop similar estimates for the same asset or liability. The Board acknowledges that those assessments will require judgment. However, the Board concluded that in situations in which similar assets or liabilities can be observed in the marketplace, an entity should make the necessary assessments (of differences) before defaulting to other valuation techniques (pricing models and methodologies).

Level 3 Estimates

C56. Level 3 estimates rely on the results of other valuation techniques (pricing models and methodologies). Based on input received from constituents, the Board understands that practical concerns about the reliability of fair value estimates center on Level 3 estimates. Because they require more estimation and assumptions, they are necessarily more subjective than Level 1 and Level 2 estimates.

C57. To mitigate those concerns, this Statement requires that Level 3 estimates be based on the results of multiple valuation techniques generally consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort. The Board concluded that because different valuation techniques tend to provide independent indications of fair value, an estimate based on the results of multiple valuation techniques is likely to be more reliable than an estimate based on the results of a single valuation technique. Accordingly, the results of those valuation techniques (the respective indications of fair value) should be evaluated, and significant differences explained, as a basis for the resulting estimate.

C58. This Statement emphasizes the need to consider multiple valuation techniques for all estimates of fair value. However, the Board agreed that because Level 1 and Level 2 estimates are based on quoted prices in active markets, the results of other valuation techniques may not provide significant additional information about those estimates. Further, in some cases, the information necessary to apply valuation techniques consistent with all valuation approaches might not be available without undue cost and effort. The Board concluded that regardless of whether one or more valuation techniques (and approaches) are used, the objective is to select the valuation technique that best approximates what an exchange price would be in the circumstances.

C59. The reliability of Level 3 estimates depends on the reliability of the inputs used. Accordingly, an entity should use as many market inputs as are available and about which there is a consensus in order to replicate an exchange price for the asset or liability being measured. In that regard, the Board clarified that market inputs, including those derived from active markets, often are relevant for Level 3 estimates, even though the asset or liability being measured is not exchanged in such markets. If available, observable prices, adjusted as appropriate, should be used in developing those estimates.

C60. In this Statement, the Board acknowledged, as it did in Concepts Statement 7, that in some cases relevant market inputs for assets and liabilities that are not exchanged in active markets might not be available without undue cost and effort, requiring the use of significant entity inputs. Paragraph 38 of Concepts Statement 7 explains:

... an entity that uses cash flows in accounting measurements often has little or no information about some or all of the assumptions that marketplace participants would use in assessing the fair value of an asset or liability. In those situations, the entity must necessarily use the information that is available without undue cost and effort in developing cash flow estimates. The use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.

C61. The Board decided that valuation techniques that rely on significant entity inputs, requiring more subjective estimation methods and extrapolation, may be used for Level 3 estimates, but only as a practical expedient and to the extent that such estimates are not precluded under other applicable pronouncements (for example, as in EITF Issue 02-3). The Board clarified that regardless of whether market inputs or entity inputs are used for Level 3 estimates, the measurement objective remains the same—fair value.

Restricted Securities

C62. Some pronouncements within the Phase 1 scope require fair value estimates for restricted securities (that is, securities for which sale is legally restricted, by governmental or contractual requirement, for a specified period), but those pronouncements do not provide guidance for developing those estimates.

C63. The Board decided to address that issue in this Statement. Specifically, the Board decided that the fair value of restricted securities should be estimated using the quoted price for an otherwise identical unrestricted security, adjusted for the effect of the restriction, considering factors such as the nature and duration of the restriction, the volatility of that unrestricted security, and the risk-free interest rate. The Board agreed that because the resulting discount amount depends largely on facts and circumstances specific to the particular security and issuer, it would not be possible to identify all factors that should be considered in all cases. Instead, this Statement includes general guidance for determining the discount amount that incorporates the relevant guidance in SEC ASR No. 113, *Statement Regarding “Restricted Securities”* (refer to Appendix B). The Board clarified that the guidance in this Statement should apply regardless of the duration of the restriction. Accordingly, it applies in measuring equity securities with restrictions that terminate within one year, which are included in the scope of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The Board believes that in applying that guidance, an entity should document the method used, but it concluded that an entity should have flexibility in selecting that method.

Disclosures

C64. In its discussions, the Board observed that some but not all of the pronouncements within the Phase 1 scope require disclosures about the use of fair value to measure the assets and liabilities covered under those pronouncements. Further, the required disclosures vary.

C65. The Board decided that having addressed the need for increased consistency and comparability in fair value measurements, this Statement should also address the need for enhanced disclosures about those measurements. The Board noted that at initial recognition (including in a business combination) many assets and liabilities are measured in the statement of financial position at amounts that approximate fair value. For practical reasons, the Board decided that the disclosures required by this Statement should be limited to situations in which fair value is used to remeasure those assets and liabilities in subsequent periods, whether on a recurring (or ongoing) basis or on a nonrecurring (or periodic) basis. Those disclosures would include, in one place, the similar disclosures required under other pronouncements. The Board is addressing reporting issues broadly in its project on financial performance reporting by business enterprises. However, based on input received from the UAC and others, the Board concluded that until such time as a final Statement in that project is issued, the disclosures required by this Statement would provide information that is useful to users of financial statements in assessing the effects of the fair value measurements used in financial reporting.

C66. The Board believes that because the disclosures required by this Statement rely largely on information used to develop the related fair value measurements, entities should have the information necessary to make the disclosures. In that regard, the Board observed that some entities (in particular, entities in the financial services industry) already are making similar disclosures in SEC filings as part of disclosures about critical accounting policies.

C67. The disclosures required by this Statement supplement, and do not replace, the disclosures required by other existing pronouncements. The Board agreed that standardizing disclosures for all assets and liabilities measured at fair value (for example, requiring disclosure of assumptions used in developing all estimates of fair value) would not be practical. The Board noted that the sheer volume of information that would need to be disclosed in order for that information to be meaningful would exceed any potential benefits. Instead, this Statement establishes a broad disclosure objective, which the Board expects to use as a basis for considering more specific disclosures in pronouncements that require fair value measurements on a project-by-project basis.

Effective Date and Transition

C68. The Board decided that this Statement should be effective for financial statements issued for fiscal years beginning after June 15, 2004, and all interim periods within those fiscal years. Because the methods for developing fair value estimates in this Statement apply only for the fair value estimates currently required under other pronouncements, the Board believes that the effective date of this Statement provides sufficient time for entities, their auditors, and users of financial statements to analyze, interpret, and prepare for implementation of the provisions of this Statement. The Board encourages earlier application.

C69. Except as discussed in paragraphs 70–72, the changes in methods for estimating fair value that would result from applying this Statement are, to a large extent, qualitative, focusing on the reliability of the estimates (for example, through the use of multiple valuation techniques, especially for Level 3 estimates). The Board concluded that changes in the methods (or combination of methods) used for those estimates would not be distinguishable from changes in the estimates, for example, as new events occur or as new additional information is obtained (that is, from better insight or improved judgment). Accordingly, this Statement requires that those changes be applied prospectively.

C70. For financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices, this Statement prescribes the method that should be used to measure fair value. For changes resulting from application of the prescribed method for bid-asked spread measurements, the Board decided to require a retroactive transition approach applied by reporting a cumulative-effect adjustment (catch-up approach). In reaching that decision, the Board considered but rejected both a retroactive transition approach applied by restating the financial statements of prior periods (restatement approach) and a prospective transition approach.

C71. The Board acknowledged that a restatement approach would result in the greatest level of consistency and comparability and that the information necessary to restate prior periods likely would be available. However, the Board observed that requiring restatement could require some entities to revalue millions of positions in prior periods. For those entities, the Board concluded that a restatement approach would be costly and burdensome. Further, because the changes resulting from application of the prescribed methods affect financial instruments with ongoing fair value measurement requirements, the Board decided that a prospective transition approach would require some form of a

grandfathering provision to provide a runoff period for the related positions held at the date the Statement is initially applied. The Board concluded that the runoff could extend for varying periods, having a significant ongoing effect on the comparability and consistency of reported amounts in the financial statements for future periods.

C72. The Board concluded that a catch-up approach is the most reasonable and practical transition approach for changes resulting from application of the prescribed method (for bid-asked spread measurements). Because that approach would require that entities revalue the positions held at the date this Statement is initially applied, it would achieve consistency and comparability in the financial statements for current and future periods with minimum cost and burden relative to the restatement approach and without the complexity of the prospective approach.

Benefits and Costs

C73. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

C74. The Board believes that this Statement will result in improved financial reporting. This Statement provides guidance for applying the fair value measurement objective in GAAP. Thus, the result should be increased consistency in application and, with respect to the resulting fair value measurements, increased reliability and comparability. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, emphasizes that providing comparable information enables users to identify similarities in and differences between two sets of economic events. Also, the disclosures required by this Statement should improve the quality of information provided to users of financial statements about fair value measurements.

C75. The fair value framework in this Statement builds on current practice and requirements. However, certain methods required by this Statement may result in a significant change to practice for some entities, in particular, entities applying other methods for bid-asked spread measurements and for equity securities with restrictions that terminate within one year under Statement 115. Also, for Level 3 estimates, many entities might need to apply additional valuation techniques and perform additional analysis. In addition, all entities will need to expand on their fair value disclosures. The Board acknowledges that those entities might need to make changes to comply with the requirements of this Statement, incurring one-time costs. However, the Board believes that the benefits from more reliable, consistent, and comparable information will be ongoing.

International Financial Reporting Standards

C76. Many International Financial Reporting Standards (IFRS) require fair value measurements. Like the FASB, the International Accounting Standards Board (IASB) has addressed issues related to fair value largely in the context of financial instruments, more recently, in IAS 39 (revised). The comparable fair value measurement guidance in IAS 39 (revised) (paragraphs AG69–AG82) was considered in developing this Statement and is largely consistent with the guidance in this Statement, except as otherwise specified. In addition, IAS 39 (revised) does not permit the use of blockage factors in estimating the fair value of blocks.

C77. The IASB and staff of the Canadian Accounting Standards Board are working on a research project that is addressing measurement issues more broadly at the concepts level. The focus of that project is on the relevance and reliability of all possible measurement bases at initial recognition (and for subsequent asset impairments). The research project will provide a basis for the IASB and other national standard setters to initiate projects to improve the measurement guidance in their conceptual frameworks. If initiated, such a project (or projects) would provide the Board with an opportunity to work together with national standard setters on conceptual issues in the conceptual phase of this project, consistent with other convergence initiatives.

Alternative Views

C78. Three Board members disagree with the decision in this Exposure Draft not to change existing practice for large positions (blocks) of securities because they believe that existing practice is not consistent with the definition of fair value that is used in this Exposure Draft. All three Board members agree with the reasoning in Statement 107, which requires that the fair value of unrestricted equity securities in active markets be measured as individual trading units regardless of the quantity held. This reasoning is consistent with the view in this Exposure Draft that for items traded in active markets the reference market for fair value measurement is the active market to which an entity has immediate access, or if the entity has immediate access to multiple active markets, the most advantageous market. Furthermore, the price that forms the basis for a fair value measurement of an item traded in an active market (or multiple active markets) is selected without regard to an entity's intent to transact at that price. Basing the fair value on the quoted price for an actively traded security, regardless of the size of the position held, results in comparable reporting; adjusting the fair value for the size of the position introduces management intent (to trade in blocks) into the measurement and thereby reduces comparability. In addition, following the reasoning used in Statement 107, those Board members conclude that the quoted price provides useful information because investors regularly rely on quoted prices for decision making. Finally, the decision to exchange a large position in equity securities in a block at a price lower than would be available for exchanges of the same number of securities in smaller groups is a decision whose consequences should be reported when that decision is executed. Until that transaction occurs, the holder of the block has the opportunity to effect the transaction either in the block market or in another market.

Appendix D

AMENDMENTS TO EXISTING PRONOUNCEMENTS

D1. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, is amended as follows:

a. Paragraph 9:

Under the market value method, an investor recognizes both dividends received and changes in market prices of the stock of the investee company as earnings or losses from an investment. Dividends received are accounted for as part of income from the investment. In addition, an investor adjusts the carrying amount of its investment based on the market value of the investee's stock. Change in market value since the preceding reporting date is included in results of operations of the investor. Reporting of investments in common stock at market value (~~or at approximate fair value if market value is not available~~) is considered to meet most closely the objective of reporting the economic consequences of holding the investment. However, the market value method is now used only in special circumstances. While the Board believes the market value method provides the best presentation of investments in some situations, it concludes that further study is necessary before the market value method is extended beyond current practice.

D2. APB Opinion No. 21, *Interest on Receivables and Payables*, is amended as follows:

a. Footnote 1 to paragraph 1:

~~*Present value* is the sum of the future payments discounted to the present date at an appropriate rate of interest. The Appendix contains a description of the valuation process.~~

b. Paragraph 12:

Note exchanged for property, goods, or service. When a note is exchanged for property, goods, or service in a bargained transaction entered into at arm's length, there should be a general presumption that the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related funds. That presumption, however, must not permit the form of the transaction to prevail over its economic substance and thus would not apply if (1) interest is not stated, or (2) the stated interest rate is unreasonable, ~~(paragraphs 13 and 14)~~ or (3) the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the market value of the note at the date of the transaction. In these circumstances, the note, the sales price, and the cost of the property, goods, or service exchanged for the note should be recorded at the fair value of the property, goods, or services or at an amount that reasonably approximates the

market value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium should be accounted for as an element of interest over the life of the note (paragraph 15). In the absence of established exchange prices for the related property, goods, or service or evidence of the market value of the note (paragraph 9), the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest, ~~as described in paragraphs 13 and 14.~~ This determination should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

c. Paragraph 13:

Determining an appropriate interest rate. The variety of transactions encountered precludes any specific interest rate from being applicable in all circumstances. ~~However, some general guides may be stated. The choice of a rate may be affected by the credit standing of the issuer, restrictive covenants, the collateral, payment and other terms pertaining to the debt, and, if appropriate, the tax consequences to the buyer and seller. The prevailing rates for similar instruments of issuers with similar credit ratings will normally help determine the appropriate interest rate for determining the present value of a specific note at its date of issuance. In any event, the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction. For purposes of this Opinion,~~ The objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity.

d. Paragraph 18 (Appendix A):

Present value concepts—discount rate adjustment technique. Upon issuance of a note or bond, the issuer customarily records as a liability the face or principal amount of the obligation. Ordinarily, the recorded liability also represents the amount which is to be repaid upon maturity of the obligation. The value recorded in the liability account, however, may be different from the proceeds received or the present value of the obligation at issuance if the market rate of interest differs from the coupon rate of interest. For example, consider the issuance of a \$1,000, 20-year bond which bears interest at 10% annually. If we assume that 10% is an appropriate market rate of interest for such a bond, the proceeds (fair value) at issuance will be \$1,000. The bond payable would be recorded at \$1,000 which represents the amount repayable at maturity and also the present value at issuance which is equal to the proceeds. However, under similar circumstances, if the prevailing market rate were more (less) than 10%, a 20-year 10% bond with a face amount of \$1,000 would usually have a value at

issuance and provide cash proceeds of less (more) than \$1,000. The significant point is that, upon issuance, a bond is valued at (1) the present value of the future coupon interest payments plus (2) the present value of the future principal payments (face amount). These two sets of future cash payments are discounted at the prevailing market rate of interest (for an equivalent security) at the date of issuance of the debt. As the 8% and 12% columns show, premium or discount arises when the prevailing market rate of interest differs from the coupon rate:

	<u>Assume prevailing market rate of</u>		
	<u>10%</u>	<u>8%</u>	<u>12%</u>
1. Present value of annual interest payments of \$100 (the coupon rate of 10% of \$1,000) for 20 years	\$ 851	\$ 982	\$ 747
2. Present value of payment of the face amount of \$1,000 at the end of year 20	<u>149</u>	<u>215</u>	<u>104</u>
Present value and proceeds (<u>fair value</u>) at date of issuance	<u>\$ 1,000</u>	<u>\$ 1,197</u>	<u>\$ 851</u>

e. Paragraph 19 (Appendix A):

In the case of a \$1,000 noninterest bearing 20-year note, where the prevailing market rate for comparable credit risks is 10%, the following valuation should be made:

1. Present value of no annual interest payments	\$ 0
2. Present value of payment of the face amount of \$1,000 at the end of year 20	<u>149</u>
Present value and proceeds (<u>fair value</u>) at date of issuance	<u>\$149</u>

Comparison of the results of the illustrations in paragraph 18 with the illustration above shows the significant impact of interest.

D3. APB Opinion No. 28, *Interim Financial Reporting*, is amended as follows:

a. Paragraph 30:

1. The following information about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position pursuant to FASB Statement No. XXX, *Fair Value Measurements*:

(1) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities), (a) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities, (b) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the

extent to which market inputs were used), and (c) the effect of the remeasurements on earnings for the period (unrealized gains or losses) relating to those assets and liabilities still held at the reporting date.

- (2) For assets and liabilities that are remeasured at fair value on a nonrecurring (or periodic) basis during the period (for example, impaired assets), (a) the reason for the remeasurements, (b) the fair value amounts, (c) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and (d) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.

D4. APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, is amended as follows:

- a. Paragraph 18 and its related footnote 5:

The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values⁵ of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement). If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

⁵~~See paragraph 25 for determination of fair value.~~

- b. Paragraph 20:

Fair Value Not Determinable. Accounting for a nonmonetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits ~~(paragraph 25).~~

c. Paragraph 25:

~~Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.~~

D5. FASB Statement No. 13, *Accounting for Leases*, is amended as follows:

a. Paragraph 22:

If a sale to a third party of property subject to an operating lease or of property that is leased by or intended to be leased by the third-party purchaser to another party is not to be recorded as a sale because of the provisions of paragraph 21 above, the transaction shall be accounted for as a borrowing. (Transactions of these types are in effect collateralized borrowings.) The proceeds from the "sale" shall be recorded as an obligation on the books of the "seller." Until that obligation has been amortized under the procedure described herein, rental payments made by the lessee(s) under the operating lease or leases shall be recorded as revenue by the "seller," even if such rentals are paid directly to the third-party purchaser. A portion of each rental shall be recorded by the "seller" as interest expense, with the remainder to be recorded as a reduction of the obligation. ~~The interest expense shall be calculated by application of a rate determined in accordance with the provisions of APB Opinion No. 21, "Interest on Receivables and Payables," paragraphs 13 and 14.~~ The leased property shall be accounted for as prescribed in paragraph 19(a) for an operating lease, except that the term over which the asset is depreciated shall be limited to the estimated amortization period of the obligation. The sale or assignment by the lessor of lease payments due under an operating lease shall be accounted for as a borrowing as described above.

D6. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, is amended as follows:

a. Footnote 2 to paragraph 7:

~~Defined in paragraph 13.~~

b. Paragraph 13, as amended by FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*:

A debtor that transfers its receivables from third parties, real estate, or other assets to a creditor to settle fully a payable shall recognize a gain on restructuring of payables. The gain shall be measured by the excess of (i) the carrying amount of the payable settled (the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs) over (ii) the fair value of the assets transferred to the creditor.⁵ ~~The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows* may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.~~⁶

- c. Footnote * to paragraph 13, added by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*:

~~This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.~~

- d. Footnote 6 to paragraph 13, as amended by FASB Statement No. 141, *Business Combinations*:

~~Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 37 and 38 of Statement 141, paragraphs 12-14 of *APB Opinion No. 21, "Interest on Receivables and Payables,"* and paragraph 25 of *APB Opinion No. 29, "Accounting for Nonmonetary Transactions."*~~

- e. Paragraph 28, as amended by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*:

A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, shall account for those assets (including an equity interest) at their fair value at the time of the restructuring ~~(see paragraph 13 for how to measure fair value).~~¹⁶ A creditor that receives long-lived assets that will be sold from a debtor in full satisfaction of a receivable shall account for those assets at their fair value less cost to sell, as that term is used in paragraph 34 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The excess of (i) the recorded investment in the receivable¹⁷ satisfied over (ii) the fair value of assets received (less cost to sell, if required above) is a loss to be recognized. For purposes of

this paragraph, losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, shall be included in measuring net income for the period.

D7. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, is amended as follows:

a. Paragraph 47(l)(i):

If satisfaction of the retained production payment is reasonably assured. The seller of the property, who retained the production payment, shall record the transaction as a sale, with recognition of any resulting gain or loss. The retained production payment shall be recorded as a receivable, with interest accounted for in accordance with the provisions of *APB Opinion No. 21*, "Interest on Receivables and Payables." The purchaser shall record as the cost of the assets acquired the cash consideration paid plus the present value (~~determined in accordance with APB Opinion No. 21~~) of the retained production payment, which shall be recorded as a payable. The oil and gas reserve estimates and production data, including those applicable to liquidation of the retained production payment, shall be reported by the purchaser of the property (paragraphs 59E–59L).

D8. FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, is amended as follows:

a. Paragraph 11, as amended by FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*:

Plan investments, whether equity or debt securities, real estate, or other (excluding insurance contracts) shall be presented at their fair value at the reporting date. ~~The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if there is an active market for the investment. If there is not an active market for an investment but there is such a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows* may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved.~~⁵

b. Footnote * to paragraph 11, added by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*:

~~This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.~~

- c. Footnote 5 to paragraph 11:

~~For an indication of factors to be considered in determining the discount rate, see paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment shall reflect the brokerage commissions and other costs normally incurred in a sale.~~

D9. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, is amended as follows:

- a. Paragraph 19 and its related footnote *, which was added by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*:

Real estate acquired in settling mortgage guaranty and title insurance claims shall be reported at fair value, ~~that is, the amount that reasonably could be expected to be received in a current sale between a willing buyer and a willing seller. If no market price is available, the expected cash flows* (anticipated sales price less maintenance and selling costs of the real estate) may aid in estimating fair value provided the cash flows are discounted at a rate commensurate with the risk involved.~~ Real estate acquired in settling claims shall be separately reported in the balance sheet and shall not be classified as an investment. Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to claim costs incurred.

~~*This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.~~

D10. FASB Statement No. 63, *Financial Reporting by Broadcasters*, is amended as follows:

- a. Paragraph 4:

A licensee shall report the asset and liability for a broadcast license agreement either (a) at the present value of the liability ~~calculated in accordance with the provisions of APB Opinion No. 21, *Interest on Receivables and Payables*, fair value of the liability~~ or (b) at the gross amount of the liability. If ~~the~~ a present value approach technique is used to estimate fair value, the difference between the gross and net liability shall be accounted for as interest in accordance with ~~Opinion 21~~ APB Opinion No. 21, *Interest on Receivables and Payables*.

- b. Paragraph 8:

Broadcasters may **barter** unsold advertising time for products or services. All barter transactions except those involving the exchange of advertising time for

network programming³ shall be reported at the estimated fair value of the product or service received, ~~in accordance with the provisions of paragraph 25 of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*.~~ Barter revenue shall be reported when commercials are broadcast, and merchandise or services received shall be reported when received or used. If merchandise or services are received prior to the broadcast of the commercial, a liability shall be reported. Likewise, if the commercial is broadcast first, a receivable shall be reported.

c. Paragraph 38:

For purposes of imputing interest ~~in accordance with Opinion 21,~~ it is assumed that the \$1,000,000 payment on July 31, 19X1 and the \$6,000,000 payments on January 1, 19X2 and 19X3 relate to films A and B and the \$6,000,000 payment on January 1, 19X4 relates to films C and D. Other simplifying assumptions or methods of assigning the payments to the films could be made.

d. Paragraph 39:

Asset and Liability Recognition (~~Present Value Approach~~Fair Value Approach)

e. Paragraph 40:

Expense Recognition (~~Present Value Approach~~Fair Value Approach)

D11. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, is amended as follows:

a. Summary:

Mortgage loans and mortgage-backed securities held for sale are reported at the lower of cost or ~~market~~fair value. Origination costs associated with loan applications received directly from borrowers are expensed as period costs. The premium paid for the right to service loans in a purchase of mortgage loans ordinarily is capitalized as the cost of acquiring that right.

b. Paragraph 4, as amended by FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*:

Mortgage loans held for sale shall be reported at the lower of cost or ~~market~~fair value, determined as of the balance sheet date. If a mortgage loan has been the hedged item in a fair value hedge, the loan's "cost" basis used in lower-of-cost-or-~~market~~fair value accounting shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of FASB Statement No. 133,

Accounting for Derivative Instruments and Hedging Activities. The amount by which cost exceeds ~~market~~fair value shall be accounted for as a valuation allowance. Changes in the valuation allowances shall be included in the determination of net income of the period in which the change occurs. Mortgage-backed securities held by not-for-profit organizations shall be reported at fair value in accordance with the provisions of FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*.

- c. Paragraph 6, as amended by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, Statement 115, and Statement 134:

A mortgage loan transferred to a long-term-investment classification shall be transferred at the lower of cost or ~~market~~fair value on the transfer date. Any difference between the carrying amount of the loan and its outstanding principal balance shall be recognized as an adjustment to yield by the interest method.² A mortgage loan shall not be classified as a long-term investment unless the mortgage banking enterprise has both the ability and the intent to hold the loan for the foreseeable future or until maturity. After the securitization of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process.

- d. Paragraph 9, as amended by Statement 115, Statement 133, and FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*:

The ~~market~~fair value of mortgage loans and mortgage-backed securities held for sale shall be determined by type of loan. At a minimum, separate determinations of ~~market~~fair value for residential (one- to four-family dwellings) and commercial mortgage loans shall be made. Either the aggregate or individual loan basis may be used in determining the lower of cost or ~~market~~fair value for each type of loan. ~~Market-Fair~~ value for loans subject to investor purchase commitments (committed loans) and loans held on a speculative basis (uncommitted loans)³ shall be determined separately as follows:

- a. *Committed Loans.* ~~Market-Fair~~ value for mortgage loans covered by investor commitments shall be based on fair values.
- b. *Uncommitted Loans.* ~~Market-Fair~~ value for uncommitted loans shall be based on the market in which the mortgage banking enterprise normally operates. That determination would include consideration of the following:
 - (1) [This subparagraph has been deleted.]
 - (2) Market prices and yields sought by the mortgage banking enterprise's normal market outlets

- (3) **Quoted Government National Mortgage Association (GNMA)** security prices or other public market quotations for long-term mortgage loan rates
 - (4) **Federal Home Loan Mortgage Corporation (FHLMC)** and **Federal National Mortgage Association (FNMA)** current delivery prices
- c. *Uncommitted Mortgage-Backed Securities.* Fair value for uncommitted mortgage-backed securities that are collateralized by a mortgage banking enterprise's own loans ordinarily shall be based on the market value of the securities. If the trust holding the loans may be readily terminated and the loans sold directly, fair value for the securities shall be based on the ~~market~~fair value of the loans or the securities, depending on the mortgage banking enterprise's sales intent. Fair value for other uncommitted mortgage-backed securities shall be based on published mortgage-backed securities yields.
- e. Paragraph 10, as amended by Statement 140:

Capitalized costs of acquiring rights to service mortgage loans, associated with the purchase or origination of mortgage loans (paragraph 13 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*), shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or ~~market~~fair value.
- f. Paragraph 12, as amended by Statement 115:

The carrying amount of mortgage loans to be sold to an **affiliated enterprise** shall be adjusted to the lower of cost or ~~market~~fair value of the loans as of the date management decides that a sale to an affiliated enterprise will occur. The date shall be determined based on, at a minimum, formal approval by an authorized representative of the purchaser, issuance of a commitment to purchase the loans, and acceptance of the commitment by the selling enterprise. The amount of any adjustment shall be charged to income.
- g. Paragraph 29, as amended by Statement 115:

The method used in determining the lower of cost or ~~market~~fair value of mortgage loans (that is, aggregate or individual loan basis) shall be disclosed.

D12. FASB Statement No. 66, *Accounting for Sales of Real Estate*, is amended as follows:

- a. Footnote 6 to paragraph 23:

~~Paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*, provide criteria for selecting an appropriate rate for present value calculations.~~

- b. Footnote 22 to paragraph 49:

The credit to income resulting from the change is the profit not yet recognized less (a) a discount, if required, to reduce the receivable balances to their present values at the date of change to the percentage-of-completion method (using the appropriate interest rates, ~~as specified in paragraphs 13 and 14 of Opinion 21,~~ in effect at the time of the original sales) and (b) the liability (also discounted) for remaining future performance. The computation is illustrated in paragraph 97.

- c. Footnote 24 to paragraph 68 (Appendix B):

~~Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.~~

- d. Footnote 25 to paragraph 70 (Appendix B):

~~Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.~~

D13. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, is amended as follows:

- a. Paragraph 8(b):

If an amenity is to be sold separately or retained by the developer, capitalizable costs of the amenity in excess of its estimated **fair value** as of the expected date of its substantial physical completion shall be allocated as common costs. The fair value of a parcel is affected by its physical characteristics, its probable ultimate use, and the time required for the buyer to make such use of the property considering access, development plans, zoning restrictions, and market absorption factors. For the purpose of determining the amount to be capitalized as common costs, the amount of cost previously allocated to the amenity shall not be revised after the amenity is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, results in a gain or loss that shall be included in net income in the period in which the sale occurs.

- b. Paragraph 28 (glossary):

Fair Value

~~The amount in cash or cash equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (i.e., selling price), that is, other than in a forced or liquidation sale. The fair value of a parcel is affected by its physical characteristics, its probable ultimate use, and the time required for the buyer to make such use of the property considering access, development plans, zoning restrictions, and market absorption factors.~~

D14. FASB Statement No. 87, *Employers' Accounting for Pensions*, is amended as follows:

- a. Paragraph 49, as amended by FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, and effectively amended by FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*:

For purposes of measuring the minimum liability required by the provisions of paragraph 36 and for purposes of the disclosures required by paragraphs 5 and 8 of FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, plan investments, whether equity or debt securities, real estate, or other, shall be measured at their fair value as of the **measurement date**. ~~The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if an active market exists for the investment. If no active market exists for an investment but such a market exists for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows* may aid in estimating fair value, provided the expected cash flows are discounted at a current rate commensurate with the risk involved.~~¹²

- b. Footnote * to paragraph 49, added by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*:

~~This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.~~

- c. Footnote 12 to paragraph 49:

~~For an indication of factors to be considered in determining the discount rate, refer to paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment shall reflect the brokerage commissions and other costs normally incurred in a sale.~~

- d. Paragraph 264 (glossary):

Fair value

~~The amount that a pension plan could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale.~~

D15. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, is amended as follows:

- a. Paragraph 65, as amended by FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, and effectively amended by FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*:

For purposes of the disclosures required by paragraphs 5 and 8 of FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, plan investments, whether equity or debt securities, real estate, or other, shall be measured at their fair value as of the measurement date. ~~The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if an active market exists for the investment. If no active market exists for an investment but an active market exists for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows* may aid in estimating fair value, provided the expected cash flows are discounted at a current rate commensurate with the risk involved.~~²⁴ (Refer to paragraph 71.)

- b. Footnote * to paragraph 65, added by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*:

~~This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.~~

- c. Footnote 21 to paragraph 65:

~~For an indication of factors to be considered in determining the discount rate, refer to paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment shall reflect the brokerage commissions and other costs normally incurred in a sale.~~

- d. Paragraph 518 (glossary):

Fair value

~~The amount that a plan could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale.~~

D16. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, is amended as follows:

- a. Paragraphs 5 and 6:

~~For purposes of this Statement, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of the instrument times that market price.~~

~~Under the definition of fair value in paragraph 5, the quoted price for a single trading unit in the most active market is the basis for determining market price and reporting fair value. This is the case even if placing orders to sell all of an entity's holdings of an asset or to buy back all of a liability might affect the price, or if a market's normal volume for one day might not be sufficient to absorb the quantity held or owed by an entity.~~

b. Paragraph 9:

Generally accepted accounting principles already require disclosure of or subsequent measurement at fair value for many classes of financial instruments. ~~Although the definitions or the methods of estimation of fair value vary to some extent, and various terms such as market value, current value, or mark to market are used, the amounts computed under those requirements satisfy the requirements of this Statement and t~~Those requirements are not superseded or modified by this Statement.

c. Paragraph 10, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*:

An entity shall disclose, either in the body of the financial statements or in the accompanying notes*, the fair value of financial instruments for which it is practicable to estimate that value. Fair value disclosed in the notes shall be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position. If a quoted market price is available, the fair value to be disclosed is the product of the number of trading units times that market price. The quoted price for a single trading unit in the most active market is the basis for reporting fair value. This is the case even if placing orders to sell all of an entity's holdings of an asset or to buy back all of a liability might affect the price or if a market's normal volume for one day might not be sufficient to absorb the quantity held or owed by an entity. An entity also shall disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

d. Paragraph 11:

~~Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's~~

~~best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models). Appendix A of this Statement contains examples of procedures for estimating fair value.~~

e. Paragraphs 18–29 (Appendix A):

~~This appendix provides examples of procedures for estimating the fair value of financial instruments. The examples are illustrative and are not meant to portray all possible ways of estimating the fair value of a financial instrument in order to comply with the provisions of this Statement.~~

~~Fair value information is frequently based on information obtained from market sources. In broad terms, there are four kinds of markets in which financial instruments can be bought, sold, or originated; available information about prices differs by kind of market:~~

- ~~a. *Exchange market.* An exchange or "auction" market provides high visibility and order to the trading of financial instruments. Typically, closing prices and volume levels are readily available in an exchange market.~~
- ~~b. *Dealer market.* In a dealer market, dealers stand ready to trade either buy or sell for their own account, thereby providing liquidity to the market. Typically, current bid and asked prices are more readily available than information about closing prices and volume levels. "Over the counter" markets are dealer markets.~~
- ~~c. *Brokered market.* In a brokered market, brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. The broker knows the prices bid and asked by the respective parties, but each party is typically unaware of another party's price requirements; prices of completed transactions are sometimes available.~~
- ~~d. *Principal-to-principal market.* Principal-to-principal transactions, both originations and resales, are negotiated independently, with no intermediary, and little, if any, information is typically released publicly.~~

Financial Instruments with Quoted Prices

~~As indicated in paragraph 11 of this Statement, quoted market prices, if available, are the best evidence of fair value of financial instruments. Prices for financial instruments may be quoted in several markets; generally, the price in the most active market will be the best indicator of fair value.~~

~~In some cases, an entity's management may decide to provide further information about the fair value of a financial instrument. For example, an entity~~

may want to explain that although the fair value of its long-term debt is less than the carrying amount, settlement at the reported fair value may not be possible or may not be a prudent management decision for other reasons; or the entity may want to state that potential taxes and other expenses that would be incurred in an actual sale or settlement are not taken into consideration.

Financial Instruments with No Quoted Prices

For financial instruments that do not trade regularly, or that trade only in principal-to-principal markets, an entity should provide its best estimate of fair value. Judgments about the methods and assumptions to be used in various circumstances must be made by those who prepare and attest to an entity's financial statements. The following discussion provides some examples of how fair value might be estimated.

For some short-term financial instruments, the carrying amount in the financial statements may approximate fair value because of the relatively short period of time between the origination of the instruments and their expected realization. Likewise, for loans that reprice frequently at market rates, the carrying amount may normally be close enough to fair value to satisfy these disclosure requirements, provided there is no significant change in the credit risk of those loans.

Some financial instruments (for example, interest rate swaps and foreign currency contracts) may be "custom tailored" and, thus, may not have a quoted market price. In those cases, an estimate of fair value might be based on the quoted market price of a similar financial instrument, adjusted as appropriate for the effects of the tailoring. Alternatively, the estimate might be based on the estimated current replacement cost of that instrument.

Other financial instruments that are commonly "custom tailored" include various types of options (for example, put and call options on stock, foreign currency, or interest rate contracts). A variety of option pricing models that have been developed in recent years (such as the Black-Scholes model and binomial models) are regularly used to value options. The use of those pricing models to estimate fair value is appropriate under the requirements of this Statement.

For some predominantly financial entities, loans receivable may be the most significant category of financial instruments. Market prices may be more readily available for some categories of loans (such as residential mortgage loans) than for others. If no quoted market price exists for a category of loans, an estimate of fair value may be based on (a) the market prices of similar traded loans with similar credit ratings, interest rates, and maturity dates, (b) current prices (interest rates) offered for similar loans in the entity's own lending activities, or (c) valuations obtained from loan pricing services offered by various specialist firms or from other sources.

~~An estimate of the fair value of a loan or group of loans may be based on the discounted value of the future cash flows expected to be received from the loan or group of loans. The selection of an appropriate current discount rate reflecting the relative risks involved requires judgment, and several alternative rates and approaches are available to an entity. A single discount rate could be used to estimate the fair value of a homogeneous category of loans; for example, an entity might apply a single rate to each aggregated category of loans reported for regulatory purposes. An entity could use a discount rate commensurate with the credit, interest rate, and prepayment risks involved, which could be the rate at which the same loans would be made under current conditions. An entity also could select a discount rate that reflects the effects of interest rate changes and then make adjustments to reflect the effects of changes in credit risk. Those adjustments could include (a) revising cash flow estimates for cash flows not expected to be collected, (b) revising the discount rate to reflect any additional credit risk associated with that group of loans, or some combination of (a) and (b).~~

~~A fair value for financial liabilities for which quoted market prices are not available can generally be estimated using the same techniques used for estimating the value of financial assets. For example, a loan payable to a bank could be valued at the discounted amount of future cash flows using an entity's current incremental rate of borrowing for a similar liability; alternatively, the discount rate could be the rate that an entity would have to pay to a creditworthy third party to assume its obligation, with the creditor's legal consent (sometimes referred to as the "settlement rate").~~

~~For deposit liabilities with defined maturities, such as certificates of deposit, an estimate of fair value might also be based on the discounted value of the future cash flows expected to be paid on the deposits. The discount rate could be the current rate offered for similar deposits with the same remaining maturities. For deposit liabilities with no defined maturities, paragraph 12 of this Statement requires that the fair value to be disclosed be the amount payable on demand at the reporting date.~~

f. Paragraph 30 (Appendix B):

The examples that follow are guides to implementation of the disclosure requirements of this Statement. Entities are not required to display the information contained herein in the specific manner illustrated. Alternative ways of disclosing the information are permissible as long as they satisfy the disclosure requirements of this Statement. ~~Paragraphs 12 and 21 of this Statement describe possible additional voluntary disclosures that may be appropriate in certain circumstances.~~In some cases, an entity's management may decide to provide further information about the fair value of a financial instrument. For example, an entity may want to explain that although the fair value of its long-term debt is less than the carrying amount, settlement at the reported fair value may not be possible or may not be a prudent management

decision for other reasons, or the entity may want to state that potential taxes and other expenses that would be incurred in an actual sale or settlement are not taken into consideration.

D17. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, is amended as follows:

a. Paragraph 3:

Except as indicated in paragraph 4, this Statement establishes standards of financial accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities.*

*If a quoted market price is available, the fair value is the product of the number of trading units times that market price.

b. Footnote 2 to paragraph 3(a):

Restricted stock, for the purpose of this Statement, means equity securities for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except if that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year, such as may be the case under Rule 144 or similar rules of the SEC, is not considered restricted. However, the fair value of that security shall be determined based on the quoted price of an otherwise identical unrestricted equity security, adjusted for the effect of the restriction, in accordance with FASB Statement No. XXX, *Fair Value Measurements*.

c. Paragraph 137 (glossary), as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*:

~~Fair value~~

~~The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring~~

~~assets should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, including assumptions about interest rates, default, prepayment, and volatility.~~

D18. FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, is amended as follows:

a. Paragraph 19:

~~Quoted market prices, if available, are the best evidence of the fair value of monetary and nonmonetary assets, including services. If quoted market prices are not available, fair value may be estimated based on quoted market prices for similar assets, independent appraisals, or valuation techniques, such as the present value of estimated future cash flows. Contributions of services that create or enhance nonfinancial assets may be measured by referring to either the fair value of the services received or the fair value of the asset or of the asset enhancement resulting from the services. A major uncertainty about the existence of value may indicate that an item received or given should not be recognized.⁷~~

b. Paragraph 20:

~~The If a present value technique of estimated future cash flows using a discount rate commensurate with the risks involved is an appropriate used to measure of the fair value of unconditional promises to give cash,⁸ . Subsequent accruals of the interest element shall be accounted for as contribution income by donees and contribution expense by donors. Not-for-profit organizations shall report the contribution income as an increase in either temporarily or permanently restricted net assets if the underlying promise to give is donor restricted.~~

c. Paragraph 184 (Example 6, Appendix C):

Mission G would recognize the contributed property as an asset and as support and measure that property at its fair value (paragraph 8). Information necessary to estimate the fair value of that property could be obtained from various sources, including (a) amounts recently paid for similar properties in the locality, (b) estimates of the market value of the property by local appraisers or real estate brokers, (c) an estimate of the fair value of the property by the local tax assessor's office, or (d) estimates of its replacement cost ~~(paragraph 19)~~. This contribution is unrestricted support because the donated assets may be used for any purpose and Mission G does not have a policy of implying time restrictions on gifts of long-lived assets (paragraph 16). If Mission G's policy is to imply a time restriction, the contribution is temporarily restricted support and the restriction expires over the useful life of the building.

d. Paragraph 186 (Example 7, Appendix C):

If Museum H capitalizes its collections, Museum H would recognize the fair value of the contributed work of art received as revenue and capitalize it as an asset at its fair value (paragraphs 13~~and 19~~). The staff of Museum H is qualified to estimate the fair value of the contributed painting and evidence of its fair value exists. If Museum H does not capitalize its collections, Museum H is precluded from recognizing the contribution (paragraph 13) and would provide the information required by paragraphs 26 and 27.

e. Paragraph 208 (Example 16, Appendix C):

The 19X0 communication between Individual R and Church S specified an intention to give. The ability to modify a will at any time prior to death is well established; thus in 19X0 Church S did not receive a promise to give and did not recognize a contribution received. When the probate court declares the will valid, Church S would recognize a receivable and revenue for an unconditional promise to give at the fair value of its interest in the estate (paragraphs 8, 20, and ~~19-21~~). If the promise to give contained in the valid will was instead conditioned on a future and uncertain event, Church S would recognize the contribution when the condition was substantially met. A conditional promise in a valid will would be disclosed in notes to financial statements (paragraph 25).

D19. FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, is amended as follows:

a. Paragraph 7:

Investments in equity securities with readily determinable fair values and all investments in debt securities shall be measured at fair value in the statement of financial position.*

*If a quoted market price is available, the fair value is the product of the number of trading units times that market price.

b. Paragraph 112 (glossary), as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*:

Fair value

~~The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash~~

~~flows using a discount rate commensurate with the risks involved, option pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, including assumptions about interest rates, default, prepayment, and volatility.~~

D20. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows:

- a. Paragraph 17 and its related footnote *, which was added by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*:

~~An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value.[†] The guidance in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended, shall apply in determining the fair value of a financial instrument (derivative or hedged item). If expected future cash flows are used to estimate fair value, those expected cash flows* shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or the timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.~~

[†]If a quoted market price is available, the fair value is the product of the number of trading units times that market price. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate).

~~*This Statement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and therefore the term *expected cash flows* does not necessarily have the same meaning as that term does in Concepts Statement 7.~~

- b. Paragraph 540 (glossary):

~~Fair value~~

~~The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if~~

~~available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm's length transaction.~~

D21. FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, is amended as follows:

a. Paragraph 15:

A specified beneficiary shall recognize its rights to the assets (financial or nonfinancial) held by a recipient organization as an asset unless the recipient organization is explicitly granted variance power. Those rights are either an interest in the net assets of the recipient organization, a beneficial interest, or a receivable. If the beneficiary and the recipient organization are financially interrelated organizations, the beneficiary shall recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets of the recipient organization.⁶ If the beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets, the beneficiary shall recognize that beneficial interest, measuring and subsequently remeasuring it at fair value, ~~using a valuation technique such as the present value of the estimated expected future cash flows.~~ In all other cases, a beneficiary shall recognize its rights to the assets held by a recipient organization as a receivable and contribution revenue in accordance with the provisions of Statement 116 for unconditional promises to give.⁷

D22. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is amended as follows:

a. Paragraph 11:

Upon completion³ of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (**seller**) shall:

- c. Initially measure at fair value assets obtained and liabilities incurred in a sale~~(paragraphs 68–70)~~* or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 71 and 72).

* If a quoted market price is available, the fair value is the product of the number of trading units times that market price.

b. Paragraph 17(f):

If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

- (1) Its accounting policies for initially measuring the retained interest, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value~~(paragraphs 68–70)~~.

c. Paragraph 17(g):

If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

- (1) Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value~~(paragraphs 68–70)~~.
- (2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses,⁹ if applicable).*

*The timing and amount of future cash flows for retained interests in securitizations are commonly uncertain, especially if those interests are subordinate to more senior beneficial interests. Thus, estimates of future cash flows used for a fair value measurement depend heavily on assumptions about default and prepayment of all the assets securitized, because of the implicit credit or prepayment risk enhancement arising from the subordination.

- d. Paragraphs 68–70 and the heading preceding paragraph 68 and footnotes 20 and 21 to paragraph 69:

Fair Value

~~The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price.~~

~~If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated future cash flows,²⁰ option pricing models, matrix pricing, option adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.²¹ In measuring **financial liabilities** and servicing liabilities at fair value, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing.~~

²⁰~~FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, discusses the use of present value techniques in measuring the fair value of an asset (or liability) in paragraphs 42–54 and 75–88. The Board believes that an expected present value technique is superior to traditional “best estimate” techniques, especially in situations in which the timing or amount of estimated cash flows is uncertain, as is often the case for retained interests in transferred financial assets. Concepts Statement 7 also discusses in paragraph 44 the steps needed to complete a proper search for the “rate commensurate with the risk” in applying the traditional technique.~~

²¹~~The timing and amount of future cash flows for retained interests in securitizations are commonly uncertain, especially if those interests are subordinate to more senior beneficial interests. Applying the present value approach depends heavily on assumptions about default and prepayment of all the assets securitized, because of the implicit credit or prepayment risk enhancement arising from the subordination.~~

~~Estimates of expected future cash flows, if used to estimate fair value, shall be based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered either directly, if applying an expected cash flow approach, or indirectly through the risk-adjusted discount rate, if determining the best estimate of future cash flows.~~

- e. Paragraph 364 (glossary):

Fair value

~~Refer to paragraphs 68-70.~~

D23. FASB Statement No. 141, *Business Combinations*, is amended as follows:

- a. Paragraph F1 (glossary):

Fair value

~~The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.~~

D24. FASB Statement No. 142, *Goodwill and Other Intangible Assets*, is amended as follows:

- a. Paragraph 3:

Appendix A to this Statement provides implementation guidance on how intangible assets should be accounted for in accordance with this Statement. Appendix A is an integral part of the standards provided in this Statement. Appendix B provides background information and the basis for the Board's conclusions. Appendix C provides illustrations of some of the financial statement disclosures that this Statement requires. Appendix D lists other accounting pronouncements superseded or amended by this Statement. ~~Appendix E includes relevant excerpts from FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.~~ Appendix F provides a glossary of terms used in this Statement.

- b. Footnote 12 to paragraph 17:

~~The fair value of an intangible asset shall be estimated using the guidance in paragraphs 23-25 (except the guidance specific to estimating the fair value of a reporting unit).~~

c. Paragraph 19:

The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. ~~The guidance in paragraphs 23-25 shall be used to determine the fair value of a reporting unit.~~ If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired, thus the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss, if any.

d. Paragraph 23 and its related footnote 16:

~~The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Thus, †The fair value of a reporting unit refers to the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole.^{†6} Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. Thus, †the quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.~~

^{†6}~~Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization.~~

- e. Paragraph 24:

~~If quoted market prices are not available, the estimate of fair value shall be based on the best information available, including prices for similar assets and liabilities and the results of using other valuation techniques. A present value technique is often the best available technique with which to estimate the fair value of a group of net assets (such as a reporting unit). If a present value technique is used to measure fair value, estimates of future cash flows used in that technique shall be consistent with the objective of measuring fair value. Those cash flow estimates shall incorporate assumptions that marketplace participants would use in their estimates of fair value. If that information is not available without undue cost and effort, an entity may use its own assumptions. Those cash flow estimates shall be based on reasonable and supportable assumptions and shall consider all available evidence. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for the amounts or timing of possible cash flows, the likelihood of possible outcomes shall be considered. Concepts Statement 7 discusses the essential elements of a present value measurement (paragraph 23), provides examples of circumstances in which an entity's cash flows might differ from the market cash flows (paragraph 32), and discusses the use of present value techniques in measuring the fair value of an asset or a liability (paragraphs 39 54 and 75 88). Appendix E of this Statement incorporates those paragraphs of Concepts Statement 7.~~

- f. Appendix E is deleted.

- g. Paragraph F1 (glossary):

Fair value

~~The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.~~

D25. FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, is amended as follows:

- a. Paragraphs 6 and 7 and footnote 5 to paragraph 6:

~~Statement 5 and FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, deal with uncertainty in different ways. Statement 5 deals with uncertainty about whether a loss has been incurred by setting forth criteria to determine when to recognize a loss contingency. Concepts Statement 7 addresses measurement of liabilities and provides a measurement technique to deal with uncertainties about the amount and timing of the future cash flows necessary to settle the liability. Paragraphs 55 61 of Concepts Statement 7⁵ discuss, in detail, the relationship~~

~~between the fair value measurement objective and expected cash flow approach that is articulated in Concepts Statement 7 and accounting for contingencies under Statement 5. The guidance in Statement 5 and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, are not applicable to a liability for which the objective is to measure that liability at fair value. That is because in Statement 5 uncertainty is used to decide whether to recognize a liability, whereas in Concepts Statement 7 uncertainties in the amount and timing of settlement are incorporated into the fair value measurement of the recognized liability. This Statement requires that all asset retirement obligations within the scope of this Statement be recognized when a reasonable estimate of fair value can be made.~~

⁵Appendix F incorporates those paragraphs.

~~The fair value of a liability for an asset retirement obligation is the amount at which that liability could be settled in a current transaction between willing parties, that is, other than in a forced or liquidation transaction. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances, including prices for similar liabilities and the results of present value (or other valuation) techniques.~~

b. Paragraph 8 and its related footnotes 6 and 7:

A present value technique⁶ is often the best available technique with which to estimate the fair value of a liability for an asset retirement obligation. If a present value technique is used to estimate fair value, ~~estimates of future cash flows used in that technique shall be consistent with the objective of measuring fair value.~~⁷ ~~Concepts Statement 7 discusses two present value techniques: a traditional approach, in which a single set of estimated cash flows and a single interest rate (a rate commensurate with the risk) are used to estimate fair value, and an expected cash flow approach, in which multiple cash flow scenarios that reflect the range of possible outcomes and a credit-adjusted risk-free rate are used to estimate fair value. Although either present value technique could theoretically be used for a fair value measurement, the expected cash flow approach~~present value technique will usually be the only appropriate technique,* for an asset retirement obligation. An entity, when using that technique, shall discount the expected cash flows using a credit-adjusted risk-free rate. Thus, the effect of an entity's credit standing is reflected in the discount rate rather than in the expected cash flows. ~~As discussed in paragraph 44 of Concepts Statement 7, proper application of a traditional approach entails analysis of at least two liabilities—one that exists in the marketplace and has an observable interest rate and the liability being measured. The appropriate rate of interest for the cash flows being measured must be inferred from the observable rate of interest of some other liability, and to draw that inference the characteristics of the cash flows must be similar to those of the liability being measured. It would be rare,~~

~~if ever, that there would be an observable rate of interest for a liability that has cash flows similar to an asset retirement obligation being measured. In addition, an asset retirement obligation will usually have uncertainties in both timing and amount. In that circumstance, employing a traditional present value technique, where uncertainty is incorporated into the rate, will be difficult, if not impossible.~~

~~⁶Appendix F incorporates paragraphs 39–54 and 75–88 of Concepts Statement 7 that discuss present value techniques.~~

~~⁷Appendix F incorporates paragraph 23 of Concepts Statement 7 that discusses the essential elements of a fair value measurement.~~

~~* Proper application of a discount rate adjustment approach entails analysis of at least two liabilities—the liability that exists in the marketplace and has an observable interest rate and the liability being measured. The appropriate rate of interest for the cash flows being measured must be inferred from the observable rate of interest of some other liability, and to draw that inference the characteristics of the cash flows must be similar to those of the liability being measured. Rarely, if ever, would there be an observable rate of interest for a liability that has cash flows similar to an asset retirement obligation being measured. In addition, an asset retirement obligation usually will have uncertainties in both timing and amount. In that circumstance, employing a discount rate adjustment approach, where uncertainty is incorporated into the rate, will be difficult, if not impossible.~~

c. Paragraph 9 and its related footnote 8:

~~The cash flows used in estimates of fair value shall incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. Otherwise, an entity may use its own assumptions.⁸ Those estimates shall be based on reasonable and supportable assumptions and shall consider all available evidence. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for the timing or the amount of possible cash flows, the likelihood of possible outcomes shall be considered. An entity, when using the expected cash flow technique, shall discount the estimated cash flows using a credit-adjusted risk-free rate. Thus, the effect of the entity's credit standing is reflected in the discount rate rather than in the estimated cash flows.~~

~~⁸Paragraph 32 of Concepts Statement 7 (included in Appendix F) provides reasons why an entity's assumptions may differ from those expected by others in the marketplace.~~

d. Footnote 12 to paragraph 14:

The subsequent measurement provisions require an entity to identify undiscounted estimated cash flows associated with the initial measurement of a liability. Therefore, an entity that obtains an initial measurement of fair value from a market price or from a technique other than ~~the an expected cash flow present value approach~~technique described in Concepts Statement 7 must determine the undiscounted cash flows and estimated timing of those cash flows that are embodied in that fair value amount for purposes of applying the subsequent measurement provisions. Appendix E includes an example of the subsequent measurement of a liability that is initially obtained from a market price.

e. Paragraph A19:

~~The objective of the initial measurement of a liability for an asset retirement obligation shall be fair value. Quoted market prices are the best representation of fair value. When market prices are not available, the amount of the liability must be estimated using some other measurement technique. The use of an expected present value technique in measuring the fair value of a liability is discussed in Concepts Statement 7.~~

f. Paragraph A20 and its related footnote 17:

In estimating the fair value of a liability for an asset retirement obligation using an expected present value technique, an entity shall begin by estimating the expected cash flows that reflect, to the extent possible, a marketplace assessment of the cost and timing of performing the required retirement activities. ~~The measurement objective is to determine the amount a third party¹⁷ would demand to assume the obligation.~~ Considerations in estimating those expected cash flows include developing and incorporating explicit assumptions, to the extent possible, about all of the following:

- a. The costs that a third party would incur in performing the tasks necessary to retire the asset
- b. Other amounts that a third party would include in determining the price of settlement, including, for example, inflation, overhead, equipment charges, profit margin, and advances in technology
- c. The extent to which the amount of a third party's costs or the timing of its costs would vary under different future scenarios and the relative probabilities of those scenarios
- d. The price that a third party would demand and could expect to receive for bearing the uncertainties and unforeseeable circumstances inherent in the obligation, sometimes referred to as a market-risk premium.

It is expected that uncertainties about the amount and timing of future cash flows can be accommodated by using the expected ~~cash flow~~present value technique and therefore will not prevent the determination of a reasonable estimate of fair value.

¹⁷~~In this context, a third party is meant to encompass participants (or hypothetical participants) that provide settlement of asset retirement obligations in a market.~~

g. Paragraph A21 and its related footnote 19:

An entity shall discount ~~estimates of expected future~~ cash flows using an interest rate that equates to a risk-free interest rate adjusted for the effect of its credit standing (a credit-adjusted risk-free rate).¹⁸ ~~The risk free interest rate is the interest rate on monetary assets that are essentially risk free and that have maturity dates that coincide with the expected timing of the estimated cash flows required to satisfy the asset retirement obligation.¹⁹ Concepts Statement 7 illustrates an adjustment to the risk free interest rate to reflect the credit standing of the entity, but acknowledges that a~~ Adjustments for default risk can be reflected in either the discount rate or the ~~estimated expected~~ cash flows. The Board believes that in most situations, an entity will know the adjustment required to the risk-free interest rate to reflect its credit standing. Consequently, it would be easier and less complex to reflect that adjustment in the discount rate. In addition, because of the requirements in paragraph 15 relating to upward and downward adjustments in expected cash flows ~~estimates~~, it is essential to the operability of this Statement that the credit standing of the entity be reflected in the ~~interest~~discount rate. For those reasons, the Board chose to require that the risk-free rate be adjusted for the credit standing of the entity to determine the discount rate.

¹⁹~~In the United States, the risk free rate is the rate for zero coupon U.S. Treasury instruments.~~

h. Paragraph A26:

Revisions to a previously recorded asset retirement obligation will result from changes in the assumptions used to estimate the expected cash flows required to settle the asset retirement obligation, including changes in estimated probabilities, amounts, and timing of the settlement of the asset retirement obligation, as well as changes in the legal requirements of an obligation. Any changes that result in upward revisions to the ~~undiscounted estimated expected~~ cash flows shall be treated as a new liability and discounted at the current rate. Any downward revisions to the ~~undiscounted estimated expected~~ cash flows will result in a reduction of the asset retirement obligation. For downward revisions, the amount of the liability to be removed from the existing accrual shall be discounted at the credit-adjusted risk-free rate that was used at the time the

obligation to which the downward revision relates was originally recorded (or the historical weighted-average rate if the year(s) to which the downward revision applies cannot be determined).

i. Paragraph C1:

This appendix includes four examples that illustrate the recognition and measurement provisions of this Statement. Example 1 illustrates (a) initial measurement of a liability for an asset retirement obligation using an expected present value technique, (b) subsequent measurement assuming that there are no changes in ~~estimated~~expected cash flows, and (c) settlement of the asset retirement obligation liability (ARO liability) at the end of its term. Example 2 is similar to Example 1. However, Example 2 illustrates subsequent measurement of an ARO liability after a change in ~~estimated~~expected cash flows. Example 3 highlights the recognition and measurement provisions of this Statement for an ARO liability that is incurred over more than one reporting period. Example 4 illustrates accounting for asset retirement obligations that are conditional and that have a low likelihood of enforcement.

j. Paragraph C3:

d. A contractor would typically demand and receive a premium (market risk premium) for bearing the uncertainty and unforeseeable circumstances inherent in “locking in” today’s price for a project that will not occur for 10 years. The entity estimates the amount of that premium to be 5 percent of the ~~estimated inflation-adjusted~~expected cash flows adjusted for inflation.

k. Paragraph C4:

On December 31, 2012, the entity settles its asset retirement obligation by using its internal workforce at a cost of \$351,000. Assuming no changes during the 10-year period in the expected cash flows used to estimate the obligation, the entity would recognize a gain of \$89,619 on settlement of the obligation:

Labor	\$195,000
Allocated overhead and equipment charges (80 percent of labor)	<u>156,000</u>
Total costs incurred	351,000
ARO liability	<u>440,619</u>
Gain on settlement of obligation	<u>\$ 89,619</u>

Initial Measurement of the ARO Liability at January 1, 2003

	Expected Cash Flows <u>1/1/03</u>
Expected labor costs	\$131,250
Allocated overhead and equipment charges (.80 × \$131,250)	105,000
Contractor's markup [.20 × (\$131,250 + \$105,000)]	<u>47,250</u>
Expected cash flows before inflation adjustment	283,500
Inflation factor assuming 4 percent rate for 10 years	<u>1.4802</u>
Expected cash flows adjusted for inflation	419,637
Market-risk premium (.05 × \$419,637)	<u>20,982</u>
Expected cash flows adjusted for market risk	<u>\$440,619</u>
<u>Expected Present value using credit-adjusted risk-free rate</u> of 8.5 percent for 10 years	<u>\$194,879</u>

1. Paragraph C6:

On December 31, 2004, the entity revises its estimate of labor costs to reflect an increase of 10 percent in the marketplace. In addition, it revises the probability assessments related to those labor costs. The change in labor costs results in an upward revision to the ~~undiscounted~~ expected cash flows; consequently, the incremental expected cash flows are discounted at the current credit-adjusted risk-free rate of 8 percent. All other assumptions remain unchanged. The revised estimate of expected cash flows for labor costs is as follows:

<u>Cash Flow Estimate</u>	<u>Probability Assessment</u>	<u>Expected Cash Flows</u>
\$110,000	30%	\$ 33,000
137,500	45	61,875
192,500	25	<u>48,125</u>
		<u>\$143,000</u>

m. Paragraph C7:

**Subsequent Measurement of the ARO Liability Reflecting
a Change in Labor Cost Estimate as of December 31, 2004**

	<u>Revised Incremental Expected Cash Flows 12/31/04</u>
Incremental expected labor costs (\$143,000 – \$131,250)	\$11,750
Allocated overhead and equipment charges (.80 × \$11,750)	9,400
Contractor's markup [.20 × (\$11,750 + \$9,400)]	<u>4,230</u>
Expected cash flows before inflation adjustment	25,380
Inflation factor assuming 4 percent rate for 8 years	<u>1.3686</u>
Expected cash flows adjusted for inflation	34,735
Market-risk premium (.05 × \$34,735)	<u>1,737</u>
Expected cash flows adjusted for market risk	<u>\$36,472</u>
<u>Expected Present value of incremental liability using credit-adjusted risk-free rate of 8 percent for 8 years</u>	<u>\$19,704</u>

n. Paragraph C8:

Example 3 depicts an entity that places a nuclear utility plant into service on December 31, 2003. The entity is legally required to decommission the plant at the end of its useful life, which is estimated to be 20 years. Based on the requirements of this Statement, the entity recognizes a liability for an asset retirement obligation and capitalizes an amount for an asset retirement cost over the life of the plant as contamination occurs. The following schedule reflects the ~~undiscounted~~ expected cash flows and respective credit-adjusted risk-free rates used to measure each portion of the liability through December 31, 2005, at which time the plant is 90 percent contaminated.

<u>Date</u>	<u>Undiscounted Expected Cash Flows</u>	<u>Credit-Adjusted Risk-Free Rate</u>
12/31/03	\$23,000	9.0%
12/31/04	1,150	8.5
12/31/05	1,900	9.2

o. Paragraph C9:

On December 31, 2005, the entity increases by 10 percent its estimate of ~~undiscounted~~ expected cash flows that were used to measure those portions of the liability recognized on December 31, 2003, and December 31, 2004. ~~Because the change which results in an upward revision to the undiscounted estimated expected cash flows. Accordingly, the incremental estimated expected cash flows is discounted at the current credit-adjusted risk-free rate of 9.2 percent. As a result, of \$2,415 [\$2,300 (10 percent of \$23,000) plus \$115 (10 percent of \$1,150)], plus \$1,900 (resulting from contamination in 2005), which totals \$4,315 of incremental undiscounted cash flows are discounted at the then current credit-adjusted risk-free rate of 9.2 percent and recorded as a liability on December 31, 2005.~~

	<u>Date Incurred</u>		
	<u>12/31/03</u>	<u>12/31/04</u>	<u>12/31/05</u>
Initial measurement of the ARO liability:			
Expected cash flows adjusted for market risk	\$23,000	\$1,150	\$1,900
Credit-adjusted risk-free rate	9.00%	8.50%	9.20%
Discount period in years	20	19	18
Expected present value	\$4,104	\$244	\$390
Measurement of revision in incremental expected cash flows occurring on December 31, 2005:			
<u>Incremental</u> Revision in expected cash flows (increase of 10 percent)			\$2,415
—[((\$23,000 × 10%) + (\$1,150 × 10%))]			
Credit-adjusted risk-free rate at December 31, 2005			9.20%
Discount period remaining in years			18
Expected present value			\$495

**Carrying Amount of Liability Incurred in 2005
Plus Effect of Change in ~~Estimated~~ Expected Cash Flows**

<u>Year</u>	<u>Liability Balance 1/1</u>	<u>Accretion (9.2%)</u>	<u>Change in Cash Flow Estimate</u>	<u>New Liability</u>	<u>Liability Balance 12/31</u>
2005			\$495	\$390	\$885

Carrying Amount of Total Liability

<u>Year</u>	<u>Liability Balance 1/1</u>	<u>Accretion</u>	<u>Change in Cash Flow Estimate</u>	<u>New Liability</u>	<u>Total Carrying Amount 12/31</u>
2003				\$4,104	\$4,104
2004	\$4,104	\$369		244	4,717
2005	4,717	424	\$495	390	6,026

p. Paragraph C11:

At the end of the first year, 20 percent of the timber has been harvested. The lessee estimates that the ~~fair value of possible cash flows~~ associated with performing reforestation activities in 4 years for the portion of the land that has been harvested will be \$300,000. When estimating the fair value of the ARO liability to be recorded (using an expected present value technique), the lessee incorporates the probability that the restoration provisions will not be enforced:

<u>Possible Cash Flows Estimate</u>	<u>Probability Assessment</u>	<u>Expected Cash Flows</u>
\$300,000	10%	\$30,000
0	90	<u>0</u>
		<u>\$30,000</u>
<u>Expected Present value using credit- adjusted risk-free rate of 8.5 percent for 4 years</u>		<u>\$21,647</u>

q. Paragraph C12:

During the term of the lease, the lessee should reassess the likelihood that the lessor will require reforestation. For example, if the lessee subsequently determines that the likelihood of the lessor electing the reforestation option has

increased, that change will result in a change in the ~~estimate of future expected~~ cash flows and be accounted for as illustrated in Example 2.

- r. Appendix F is deleted.

D26. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, is amended as follows:

- a. Paragraph 22 and its related footnote 12:

~~The fair value of an asset (liability) is the amount at which that asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.¹² Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, in many instances, quoted market prices in active markets will not be available for the long lived assets (asset groups) covered by this Statement. In those instances, the estimate of fair value shall be based on the best information available, including prices for similar assets (groups) and the results of using other valuation techniques.~~

¹²~~The fair value of an asset or a disposal group refers to the amount at which the group as a whole could be bought or sold in a current single transaction. Therefore, the fair value of the group would not necessarily equate to the sum of the fair values of the individual assets and liabilities of the group.~~

- b. Paragraph 23 and its related footnote 13:

~~A present value technique is often the best available valuation technique with which to estimate the fair value of a long-lived asset (asset group). Paragraphs 39–54 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, discuss the use of two present value techniques to measure the fair value of an asset (liability).¹³ The first is expected present value, in which multiple cash flow scenarios that reflect the range of possible outcomes and a risk-free rate are used to estimate fair value. The second is traditional present value, in which a single set of estimated cash flows and a single interest rate (a rate commensurate with the risk) are used to estimate fair value. Either present value technique can be used for a fair value measurement. However, f~~For ~~long-lived assets (asset groups) that have uncertainties both in timing and amount, an expected present value technique will often be the appropriate technique. (Example 4 of Appendix A illustrates the use of that technique.)~~

¹³~~Appendix E incorporates those paragraphs of Concepts Statement 7.~~

c. Paragraph 24 and its related footnote 14:

~~If a present value technique is used, estimates of future cash flows shall be consistent with the objective of measuring fair value. Assumptions that marketplace participants would use in their estimates of fair value shall be incorporated whenever that information is available without undue cost and effort.¹⁴ Otherwise, the entity may use its own assumptions.~~

¹⁴~~Concepts Statement 7 discusses the essential elements of a present value measurement (paragraph 23) and provides reasons why an entity's estimates of cash flows might differ from those used by marketplace participants (paragraph 32). Appendix E incorporates those paragraphs.~~

d. Paragraph A6:

~~At December 31, 20X2, a manufacturing facility with a carrying amount of \$48 million is tested for recoverability. At that date, 2 courses of action to recover the carrying amount of the facility are under consideration—sell in 2 years or sell at the in 10 years (at the end of its remaining useful life) of 10 years. The facility ~~has identifiable cash flows that are largely independent of the cash flows of other assets.~~~~

e. Paragraph A7:

~~As indicated in The following table, shows the range and probability of the possible estimated cash flows associated with each of those courses of action are \$41 million and \$48.7 million, respectively. They are developed based on entity-specific assumptions about expected to result from the use and eventual disposition of the facility assuming that (a) it is sold at the end of 2 years or (b) it is sold at the end of 10 years. Among other things, the range of possible estimated cash flows considers future sales levels (volume and price) and associated manufacturing costs in varying scenarios that consider (a) the likelihood that existing customer relationships will continue, and (b) future changes in economic (market) conditions, and other relevant factors. The probability assessments consider all information available without undue cost and effort. Such assessments are by their nature subjective and, in many situations, may be limited to management's best judgment about the probabilities of the best, worst, and most likely scenarios.~~

<u>Course of Action</u>	<u>Cash Flows Estimate (Use)</u>	<u>Cash Flows Estimate (Disposition)</u>	<u>Cash Flows Estimate (Total)</u>	<u>Probability Assessment</u>	<u>Possible Cash Flows (Probability-Weighted) Cash Flows</u>
(in \$ millions)					
Sell in 2 years	\$ 8	\$30	\$38	20%	\$ 7.6
	11	30	41	50	20.5
	13	30	43	30	12.9
					<u>\$41.0</u>
Sell in 10 years	36	1	37	20%	\$ 7.4
	48	1	49	50	24.5
	55	1	56	30	16.8
					<u>\$48.7</u>

f. Paragraph A8:

As further indicated in the following table, ~~In computing the future cash flows used to test the facility for recoverability, the entity concludes that there is (a) a 60 percent probability that the facility will be sold at the end of in 2 years and (b) a 40 percent probability that the facility will continue to be used for its remaining estimated useful life of be sold in 10 years.~~²⁷ The following table shows the computation of future cash flows based on the probability of those alternative courses of action. As shown, ~~those future~~ the expected cash flows are \$44.1 million (undiscounted). Therefore, the carrying amount of the facility of \$48 million would not be recoverable.

<u>Course of Action</u>	<u>Possible Cash Flows (Probability-Weighted) Cash Flows</u>	<u>Probability Assessment (Course of Action)</u>	<u>Expected Cash Flows (Undiscounted)</u>
(in \$ millions)			
Sell in 2 years	\$41.0	60%	\$24.6
Sell in 10 years	48.7	40	19.5
			<u>\$44.1</u>

- g. Paragraph A11 and its related footnote 28:

This example illustrates the application of an expected present value technique to estimate the fair value of a long-lived asset in an impairment situation. the absence of an observable market price (paragraph 23).²⁸—It is based on the facts provided for the manufacturing facility in Example 2.

~~²⁸Present value is the current measure of an estimated future cash inflow, discounted at an interest rate for the number of periods between today and the date of the estimated cash flow. The present value of \$X in *n* periods in the future and discounted at interest of *i* per period is computed using the formula $X / (1 + i)^n$. Because all of the risks are considered in the estimates of cash flows, the entity discounts the expected cash flows for each year using the risk-free rate of interest. The risk-free rate of interest is the interest rate on monetary assets that are essentially risk-free and that have maturity dates that coincide with the expected timing of the cash flow. In the United States, the risk-free rate is the rate for zero coupon U.S. Treasury instruments. A yield curve for U.S. Treasury instruments may be used to determine the appropriate risk-free rates of interest.~~

- h. Paragraph A12 and its related footnote 29:

~~Consistent with an objective of measuring fair value, the entity's estimates of future cash flows used to test the manufacturing facility for recoverability in Example 2 are adjusted to incorporate assumptions that, based on available information, marketplace participants would use in their estimates of the fair value of the asset. The net effect of those adjustments is to increase the entity's estimates of future cash flows (on an undiscounted basis) by approximately 15 percent.~~²⁹

~~²⁹In this example, a reliable estimate of the market risk premium is not available. Paragraph 62 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, explains:~~

~~An estimate of fair value should include the price that marketplace participants are able to receive for bearing the uncertainties in cash flows—the adjustment for risk if the amount is identifiable, measurable, and significant. An arbitrary adjustment for risk, or one that cannot be evaluated by comparison to marketplace information, introduces an unjustified bias into the measurement. On the other hand, excluding a risk adjustment (if it is apparent that marketplace participants include one) would not produce a measurement that faithfully represents fair value. There are many techniques for estimating a risk adjustment, including matrix pricing, option-adjusted spread models, and fundamental analysis. However, in many cases a reliable estimate of the market risk premium may not be obtainable or the amount may be small relative to potential measurement error in the~~

~~estimated cash flows. In such situations, the present value of expected cash flows, discounted at a risk free rate of interest, may be the best available estimate of fair value in the circumstances.~~

i. Paragraph A13:

~~The following table shows by year the computation of the expected cash flows used in the measurement. They reflect the possible cash flows (probability-weighted) used to test the manufacturing facility for recoverability in Example 2, adjusted for relevant marketplace assumptions, which increases the cash flows by approximately 15 percent.* range and probability of possible cash flows expected to result from the use and eventual disposition of the facility over its remaining useful life of 10 years (Example 2), adjusted for market assumptions. It also shows by year the computation of expected cash flows.~~

~~* In this example, a market risk premium is included in the expected cash flows.~~

<u>Year</u>	<u>Total Possible Cash Flows Estimate (Market)</u>	<u>Probability Assessment</u>	<u>Expected Cash Flows (Undiscounted)</u>
	(in \$ millions)		
1	\$4.6	20%	\$.9
	6.3	50	3.2
	7.5	30	<u>2.3</u>
			\$6.4
2	\$4.6	20%	\$.9
	6.3	50	3.2
	7.5	30	<u>2.3</u>
			\$6.4
3	\$4.3	20%	\$.9
	5.8	50	2.9
	6.7	30	<u>2.0</u>
			\$5.8
4	\$4.3	20%	\$.9
	5.8	50	2.9
	6.7	30	<u>2.0</u>
			\$5.8
5	\$4.0	20%	\$.8
	5.4	50	2.7
	6.4	30	<u>1.9</u>
			\$5.4
6	\$4.0	20%	\$.8
	5.4	50	2.7
	6.4	30	<u>1.9</u>
			\$5.4

<u>Year</u>	<u>Total Possible Cash Flows Estimate (Market)</u>	<u>Probability Assessment</u>	<u>Expected Cash Flows (Undiscounted)</u>
	(in \$ millions)		
7	\$3.9	20%	\$.8
	5.1	50	2.6
	5.6	30	<u>1.7</u>
			\$5.1
8	\$3.9	20%	\$.8
	5.1	50	2.6
	5.6	30	<u>1.7</u>
			\$5.1
9	\$3.9	20%	\$.8
	5.0	50	2.5
	5.5	30	<u>1.7</u>
			\$5.0
10	\$4.9	20%	\$1.0
	6.0	50	3.0
	6.5	30	<u>2.0</u>
			\$6.0

j. Paragraph A14:

The following table shows the computation of the expected present value of the expected cash flows; that is, the sum of the present values of the expected cash flows by year, ~~which are calculated by each discounted in those cash flows~~ at a risk-free interest rate determined from the yield curve for U.S. Treasury instruments. As shown, the expected present value is \$42.3 million, which is less than the carrying amount of \$48 million. In accordance with paragraph 7, the entity would recognize an impairment loss of \$5.7 million. ~~(\$48 million less \$42.3 million).~~

<u>Year</u>	<u>Expected Cash Flows (Undiscounted)</u>	<u>Risk-Free Rate of Interest (in \$ millions)</u>	<u>Expected Present Value</u>	<u>Expected Present Value</u>
1	\$6.4	5.0%	\$6.1	
2	6.4	5.1	5.8	
3	5.8	5.2	5.0	
4	5.8	5.4	4.7	
5	5.4	5.6	4.1	
6	5.4	5.8	3.9	
7	5.1	6.0	3.4	
8	5.1	6.2	3.2	
9	5.0	6.4	2.9	
10	<u>6.0</u>	6.6	<u>3.2</u>	
	<u>\$56.4</u>		<u>\$42.3</u>	<u>\$42.3</u>

k. Appendix E is deleted.

D27. FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, is amended as follows:

a. Paragraph 5:

~~The fair value of a liability is the amount at which that liability could be settled in a current transaction between willing parties, that is, other than in a forced or liquidation transaction. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances, including prices for similar liabilities and the results of using other valuation techniques. (Certain valuation techniques are discussed in Appendix A.)~~

b. Paragraph A2 and its related footnote 13:

~~The objective of initial measurement of a liability for a cost associated with an exit or disposal activity is fair value (paragraph 3). For a liability, fair value represents the amount that a willing third party of comparable credit standing would demand and could expect to receive to assume all of the duties, uncertainties, and risks inherent in the transferor's obligation, including a profit element or risk premium.¹³~~

¹³~~Paragraph 62 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, explains:~~

~~An estimate of fair value should include the price that marketplace participants are able to receive for bearing the uncertainties in cash flows—the adjustment for risk if the amount is identifiable, measurable, and significant. An arbitrary adjustment for risk, or one that cannot be evaluated by comparison to marketplace information, introduces an unjustified bias into the measurement. On the other hand, excluding a risk adjustment (if it is apparent that marketplace participants include one) would not produce a measurement that faithfully represents fair value. There are many techniques for estimating a risk adjustment, including matrix pricing, option-adjusted spread models, and fundamental analysis. However, in many cases a reliable estimate of the market risk premium may not be obtainable or the amount may be small relative to potential measurement error in the estimated cash flows. In such situations, the present value of expected cash flows, discounted at a risk free rate of interest, may be the best available estimate of fair value in the circumstances.~~

- c. Paragraph A4 and its related footnotes 14 and 15:

A present value technique is often ~~is~~ the best available valuation technique with which to estimate the fair value of a liability for a cost associated with an exit or disposal activity. ~~FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, discusses two present value techniques.¹⁴ The first technique is expected present value, in which multiple cash flow scenarios that reflect the range of possible outcomes and a risk-free rate adjusted for the entity's credit standing¹⁵ are used to estimate fair value. The second technique is traditional present value, in which a single set of estimated cash flows and a single risk-adjusted interest rate are used to estimate fair value. In contrast to a traditional present value technique, which incorporates uncertainty in the amount and timing of cash flows in the interest rate, an expected present value technique incorporates that uncertainty in the estimated cash flows. Thus, For liabilities that have uncertainties both in timing and amount, an expected present value technique will often ~~will~~ be the appropriate valuation technique. if a liability for a cost associated with an exit or disposal activity has uncertainties in both the amount and timing of estimated cash flows.~~

¹⁴~~Paragraph 23 of Concepts Statement 7 discusses the essential elements of a present value measurement.~~

¹⁵~~When using an expected present value technique, the effect of an entity's credit standing can be reflected in either the discount rate or the estimated cash flows. However, it is usually easier and less complex to reflect that adjustment in the discount rate.~~

- d. Paragraph A5 and its related footnote 16:

~~When using a present value technique, estimates of future cash flows should incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. Otherwise, an entity may use its own estimates of future cash flows.¹⁶~~

¹⁶~~Paragraph 38 of Concepts Statement 7 explains:~~

~~As a practical matter, an entity that uses cash flows in accounting measurements often has little or no information about some or all of the assumptions that marketplace participants would use in assessing the fair value of an asset or a liability. In those situations, an entity must necessarily use the information that is available without undue cost and effort in developing cash flow estimates. The use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.~~

D28. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, is amended as follows:

- a. Paragraph D1 (glossary):

Fair value

~~The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Additional guidance on determining fair value is provided in other FASB Statements and FASB Concepts Statements.~~

D29. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, is amended as follows:

- a. Paragraph 9(b):

When a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset or entering into an operating lease), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party. ~~In the absence of observable transactions for identical or similar guarantees, expected present value measurement techniques as set forth in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, will likely provide the best estimate of fair value. Concepts Statement 7 states in its glossary that *expected present value* refers to the sum of the probability-weighted present values in a range of estimated cash flows, all discounted using the same interest rate convention." The general principles in paragraph 41 of Concepts Statement 7 are also relevant.~~

D30. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, is amended as follows:

- a. Paragraph 28:

In the absence of a cash transaction, accountants turn to other techniques for the initial measurement of an asset or liability, but the measurement objective remains the same. The process begins by determining whether others have bought or sold the same or similar items in recent cash transactions. Thus, if the entity receives U.S. Treasury securities in an exchange transaction, the initial measurement of those securities is based on the observed price of transactions by others. The same fair value objective applies in initial measurements of nonmonetary assets acquired in exchange transactions. ~~Paragraph 18 of (under APB Opinion No. 29, *Accounting for Nonmonetary Transactions*), states the basic principle as follows:~~

~~... general accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received.~~

b. Paragraph 29:

If there are no observable transactions for similar assets or liabilities, the entity may be required to use estimates of future cash flows in the measurement. The same fair value objective can be found in APB Opinion No. 21, *Interest on Receivables and Payables*. ~~Paragraph 13 of Opinion 21 concludes with the following description of the measurement objective, captured in a description of the interest rate:~~

~~The objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity.~~

c. Paragraph 30:

The principles that apply to measurements at initial recognition also apply to fresh-start measurements. ~~The interest rate described in Opinion 21 embodies the same notion as the “rate commensurate with the risks involved” described in Statement 121.~~ The Board could not identify any rationale for taking a different view in subsequent fresh-start measurements (as opposed to depreciation and amortization conventions) than the view that would pertain to measurements at initial recognition. Information that is relevant at initial recognition does not become less so if the asset or liability is subject to a fresh-start measurement.

Appendix E

REFERENCES TO PRONOUNCEMENTS

E1. This appendix lists the APB and FASB pronouncements with fair value measurement requirements within the scope of this Statement.

<u>Pronouncement</u>	<u>Title</u>
Opinion 18	The Equity Method of Accounting for Investments in Common Stock
Opinion 21	Interest on Receivables and Payables
Opinion 29	Accounting for Nonmonetary Transactions
Statement 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings
Statement 19	Financial Accounting and Reporting by Oil and Gas Producing Companies
Statement 35	Accounting and Reporting by Defined Benefit Pension Plans
Statement 45	Accounting for Franchise Fee Revenue
Statement 60	Accounting and Reporting by Insurance Enterprises
Statement 61	Accounting for Title Plant
Statement 63	Financial Reporting by Broadcasters
Statement 65	Accounting for Certain Mortgage Banking Activities
Statement 66	Accounting for Sales of Real Estate
Statement 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects
Statement 68	Research and Development Arrangements
Statement 84	Induced Conversions of Convertible Debt
Statement 87	Employers' Accounting for Pensions

<u>Pronouncement</u>	<u>Title</u>
Statement 106	Employers' Accounting for Postretirement Benefits Other Than Pensions
Statement 107	Disclosures about Fair Value of Financial Instruments
Statement 115	Accounting for Certain Investments in Debt and Equity Securities
Statement 116	Accounting for Contributions Received and Contributions Made
Statement 124	Accounting for Certain Investments Held by Not-for-Profit Organizations
Statement 126	Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities
Statement 133	Accounting for Derivative Instruments and Hedging Activities
Statement 136	Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others
Statement 138	Accounting for Certain Derivative Instruments and Certain Hedging Activities
Statement 140	Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
Statement 141	Business Combinations
Statement 142	Goodwill and Other Intangible Assets
Statement 143	Accounting for Asset Retirement Obligations
Statement 144	Accounting for the Impairment or Disposal of Long-Lived Assets
Statement 146	Accounting for Costs Associated with Exit or Disposal Activities
Statement 149	Amendment of Statement 133 on Derivative Instruments and Hedging Activities
Statement 150	Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity

Pronouncement**Title**

Interpretation 9	Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method
Interpretation 45	Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
Interpretation 46 (revised December 2003)	Consolidation of Variable Interest Entities
Technical Bulletin 84-1	Accounting for Stock Issued to Acquire the Results of a Research and Development Arrangement
Technical Bulletin 85-1	Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock
Technical Bulletin 85-5	Issues Relating to Accounting for Business Combinations
Technical Bulletin 85-6	Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt