

Hot Topic

Update on major accounting
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FASB issues proposed ASU on improving disclosures about fair value measurements

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Summary

On 28 August 2009, the Financial Accounting Standards Board (FASB) issued an exposure draft of proposed Accounting Standards Update, *Improving Disclosures about Fair Value Measurements* (the proposed ASU). The proposed ASU would amend ASC 820¹ to require additional disclosures regarding recurring and non-recurring fair value measurements. Specifically, the proposed ASU would require entities to disclose:

- ▶ the effect of using reasonably possible alternative inputs on fair value measurements that use significant unobservable (Level 3) inputs (sometimes referred to as sensitivity disclosures)
- ▶ the amount of transfers in or out of Level 1 and Level 2 and the reason for these transfers
- ▶ information in the Level 3 rollforward about purchases, sales, issuances and settlements on a gross basis

In addition to these new disclosure requirements, the proposed ASU would also amend ASC 820 to clarify existing guidance pertaining to the level of disaggregation at which fair value disclosures should be made and the requirements to disclose information about the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements.

The proposed ASU would be effective for all interim and annual periods ending after 15 December 2009, except for the requirement to provide sensitivity disclosures, which would be effective for all interim and annual periods ending after 15 March 2010.

The comment period on the proposed ASU ends on 12 October 2009.

Background

ASC 820 requires a number of disclosures about fair value measurements designed to provide users of financial statements with additional transparency regarding (i) the extent to which fair value is used to measure assets and liabilities, (ii) the inputs and assumptions used in measuring fair value and (iii) the effect of fair value measurements on earnings. While these

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¹ FASB ASC 820, *Fair Value Measurements and Disclosures* (formerly FASB Statement No. 157)

disclosures helped to increase transparency, a number of constituents have recommended that the FASB improve the disclosure requirements related to fair value measurements. The proposed ASU was issued in response to suggestions from these constituents, which included the Securities and Exchange Commission,² the International Monetary Fund³ and the FASB's Valuation Resource Group, among others.

In addition, the amendments in the proposed ASU would improve comparability with the disclosure requirements under International Financial Reporting Standards, as IFRS 7⁴ (as amended in March 2009), requires similar disclosures.

New disclosure requirements

Sensitivity disclosures

Many users of financial statements have requested that the FASB require reporting entities to provide an analysis that explains how sensitive the entities' Level 3 measurements are to changes in the unobservable assumptions used to estimate fair value.

In response, the proposed ASU requires that entities disclose the effect of changes in significant unobservable inputs that are reasonably possible and result in significant increases or decreases to Level 3 fair value measurements. For this purpose, the proposed ASU notes that significance should be judged with respect to earnings and total assets or total liabilities if fair value changes are recognized in earnings or total equity if changes in fair value are recognized in other comprehensive income.

Entities are required to disclose quantitative information about the significant inputs used (e.g., a weighted average of each significant input) and reasonably possible⁵ alternative inputs (e.g., the high and low of a reasonable range) for each class of fair value measurements (both recurring and non-recurring) classified as Level 3. The proposed ASU notes that an entity should consider the current economic environment in which it operates when determining reasonably possible alternative inputs. However, the proposed guidance is clear that a reasonably possible change in inputs would not include a "worst case" scenario. Likewise, we would not expect the analysis to consider a "best case" scenario either. Instead, the objective of the analysis is to identify and assess the variability in significant unobservable inputs in a manner that acknowledges uncertainty, but is realistic in its application.

The entity must also disclose the total effect(s) of the change(s) in input(s) to the Level 3 measurement and describe how these effect(s) were calculated. While not prescribing any specific method for performing the sensitivity analysis, the proposed ASU is clear that the entity should include the expected effect of correlation among changes in different significant inputs when more than one input is changed. Although the proposed ASU provides an illustrative example (Case D) related to the sensitivity disclosures, we expect the practical application of the proposed guidance is likely to be challenging for many entities. Therefore, we suggest interested parties provide comments and continue to monitor developments in this area.

Sensitivity disclosures are not required for Level 1 or Level 2 fair value measurements and will not be required for fair value measurements that utilize the practical expedient offered by the FASB's pending ASC update, *Measuring the Fair Value of Investments in Certain Entities that Calculate Net Asset Value Consistent with Topic 946, Financial Services-Investment Companies*, even when the practical expedient is classified as a Level 3 measurement (e.g., investments in private equity funds).

However, as previously noted, these sensitivity disclosures apply to both recurring and non-recurring Level 3 measurements subsequent to initial recognition. Therefore, these requirements are equally applicable to Level 3 fair value measurements used in goodwill impairment tests of reporting units as they are to Level 3 financial instruments.

Transfers between hierarchy levels

ASC 820-10-50-2(c)(3) currently requires that reporting entities disclose the amounts of any transfers in or out of Level 3. The proposed ASU adds a requirement to discuss the reasons for these transfers. Additionally, if transfers are determined to be significant, the proposed guidance requires that entities disclose transfers into Level 3 separately from transfers out of Level 3 (i.e., transfers must be disclosed on a gross basis).

The proposed ASU also requires entities to disclose significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers. Similar to Level 3 transfers, if significant, these transfers must be disclosed on a gross basis for each level.

Determining whether a transferred amount is significant is a matter of judgment and should be determined in relation to earnings and total assets or total liabilities if fair value changes are recognized in earnings or total equity if changes in fair value are recognized in other comprehensive income.

² See the SEC's December 2008 *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*

³ See the IMF's March 2009 working paper, *Procyclicality and Fair Value Accounting*

⁴ IFRS 7, *Financial Instruments: Disclosures*

⁵ According to the Master Glossary of the ASC, "reasonably possible" is defined as "[t]he chance of the future event or events occurring is more than remote, but less than likely." Further, the Master Glossary defines "remote" as "[t]he chance of the future event or events occurring is slight."

The proposed ASU also notes that for the purpose of these disclosures, all transfers are presumed to have occurred at the beginning of the *interim* period in which the transfer occurred.

Level 3 rollforward

For recurring fair value measurements, ASC 820 requires that entities perform a reconciliation of the beginning and ending balances of Level 3 measurements (commonly referred to as the Level 3 rollforward). This reconciliation includes changes in Level 3 balances attributable to various factors including purchases, sales, issuances and settlements of Level 3 assets and liabilities. ASC 820-10-50-2(c)(2) currently provides for presentation of these amounts on a net basis within the Level 3 rollforward. The proposed ASU amends that guidance to require separate presentation for each of these items (i.e., purchases, sales, issuances and settlements must be disclosed on a gross basis in the Level 3 rollward).

Clarification of existing disclosure requirements

Level of disaggregation

The proposed ASU clarifies that reporting entities should provide fair value disclosures by “class” rather than by “major category.” The distinction in the proposed ASU is being made due to the FASB’s belief that some constituents interpreted “major category” to mean a line item in the statement of financial position. The FASB believes that fair value disclosures would be more useful if they were presented for each “class” of assets and liabilities and therefore the proposed ASU amends ASC 820 to replace the term “major category” with the term “class.” The proposed ASU notes that a class of assets or liabilities is often a subset of assets and liabilities within a line item in the statement of financial position.

Through the issuance of FASB Staff Position No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* in April 2009, the FASB had previously provided clarifying guidance on the level of disaggregation for fair value disclosures related to debt and equity securities. This guidance stated that debt and equity securities should be disclosed at a level synonymous with “major security type” as described in ASC 320-10-50-1B and, if applicable ASC 942-320-50-2.⁶

The proposed ASU provides guidance on determining the appropriate level of disaggregation for all other assets and liabilities measured at fair value. The proposed guidance states that judgment is required in identifying the appropriate classes for disclosure purposes and notes that in making this determination entities should consider the nature and risks of the assets and liabilities, as well as their classification within the fair value hierarchy. For example, in order to achieve the disclosure objectives of ASC 820 the number of classes may need to be greater for Level 3 measurements given their higher degree or uncertainty and subjectivity.

In addition, the proposed ASU states that entities should also consider the level of disaggregated information already required for specific assets and liabilities under other US GAAP codification topics. For example, under ASC 815,⁷ disclosures related to derivative instruments are presented separately by type of contract, such as interest rate contracts, foreign exchange contracts, equity contracts, etc.

The proposed ASU amends the illustrated disclosures provided in Case A and Case B of ASC 820 to reflect the revised guidance with respect to the level of disaggregation required for fair value disclosures.

Disclosures about valuation techniques and inputs

The proposed ASU also reiterates and clarifies the need for entities to disclose the valuation techniques and inputs used in determining the fair value of each class of assets or liabilities classified as Level 2 or Level 3 in the fair value hierarchy. This requirement applies to both recurring and non-recurring fair value measurements.

Effective date

If finalized, the proposed ASU will be effective for interim and annual periods ending after 15 December 2009. However, the sensitivity disclosures required for Level 3 measurements will not be required until interim and annual periods ending after 15 March 2010.

The guidance in this proposed ASU will not be required for any previous periods presented for comparative purposes in the period of initial adoption. For periods subsequent to initial adoption, the guidance in this proposed ASU will only be required for periods that ended after the period of initial adoption.

Cost-benefit considerations

The FASB believes that financial statement users will benefit from the improved disclosures proposed in the exposure draft, and that the benefit of increased transparency in financial reporting will outweigh the cost of complying with the new requirements. The FASB also states its belief that except for the sensitivity disclosures for Level 3 measurements, the information required to comply with the proposed guidance should generally be available to reporting entities without significant changes to their current information systems.

⁶ Formerly FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

⁷ FASB ASC 815, *Derivatives and Hedging* (formerly FASB Statement No. 133 as amended by FASB Statement No. 161)

However, several financial statement preparers who volunteered to participate in the FASB's preparer outreach effort expressed concerns about the proposed sensitivity disclosures. On the basis of these concerns, and in order to refine its own cost-benefit assessment, the FASB has included a number of questions in the exposure draft aimed at seeking additional input from both preparers and users. Specifically, the FASB is seeking feedback from preparers regarding the operationality and cost of providing sensitivity disclosures. The FASB is seeking input from users about how, specifically, they would use and benefit from these disclosures. Finally, the FASB is seeking insights from IFRS financial statement preparers about the approach they plan to use in order to comply with similar sensitivity disclosure requirements in IFRS 7.

The comment period on this proposed ASU ends on 12 October 2009. We would encourage interested parties to provide their views on this important topic.

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