

Hot Topic

Update on major accounting
and auditing activities

FASB issues proposal on measurement of liabilities at fair value

Contents

Summary.....	1
Background	1
Measurement	2
Effective date	2

Summary

On 01 May 2009, the FASB issued proposed FASB Staff Position No. FAS 157-f, "Measuring Liabilities under FASB Statement No. 157" (the proposed FSP). The proposed FSP is a revised exposure draft of FASB Staff Position No. FAS 157-c, which was originally issued 18 January 2008 under the same name. The proposed FSP applies to the fair value measurement of liabilities within the scope of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (Statement 157), and is aimed at addressing several key issues with respect to estimating the fair value of liabilities in accordance with Statement 157. Among other things, the guidance clarifies how the price of a traded debt security (i.e., an asset value) should be considered in estimating the fair value of the issuer's liability.

If finalized as proposed, the proposed FSP would be effective for the first reporting period after its issuance. The comment period ends on 1 June 2009.

Background

Statement 157 defines the fair value of a liability as the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date. The definition presumes that the liability continues (as it is transferred, not settled) and that nonperformance risk is the same before and after the transfer. As such, the reporting entity must consider its own credit risk in measuring the fair value of the liability.

Numerous questions have arisen in practice about how to measure the fair value of a liability. In particular, some constituents pointed out that liabilities typically are not permitted to be transferred, and generally are settled directly with the creditor. In the rare circumstance in which a liability could be transferred, the transferee may not have the same nonperformance risk as the transferor. Questions also have arisen about how the price of traded debt securities (i.e., asset values) should be considered when estimating the fair value of an obligation associated with these securities (i.e., liability value).

This and many of the publications produced by our US Professional Practice Group, are available free on AccountingLink at ey.com/us/accountinglink

Your gateways to Ernst & Young technical accounting guidance

AccountingLink at ey.com/us/accountinglink offers easy access to many of the publications produced by our US Professional Practice Group. AccountingLink is available free of charge.

Our **Global IFRS website** at ey.com/ifrs offers online resources that provide more detail about IFRS, as well as issues to consider as you research the potential impact of IFRS on your company.

GAAIT-Client Edition contains Ernst & Young's comprehensive proprietary technical guidance, as well as all standard-setter content. GAAIT-Client Edition is available through a paid subscription.

Ernst & Young LLP

Assurance | Tax | Transactions | Advisory

© 2009 Ernst & Young LLP.
All Rights Reserved.

SCORE No. BB1752

Ernst & Young refers to a global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young LLP is a client-serving member firm located in the US.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decision.

Measurement

When a quoted price in an active market for the identical liability is not available (as will often be the case), the proposed FSP requires that the fair value of a liability be measured using one of the following approaches, which should maximize the use of relevant observable inputs and minimize the use of unobservable inputs:

- ▶ The quoted price of the identical liability when traded as an asset in an active market
- ▶ The quoted price of the identical liability or the identical liability when traded as an asset in markets that are not active
- ▶ The quoted price for similar liabilities or similar liabilities when traded as assets in markets that are active
- ▶ Another valuation technique that is consistent with the principles of Statement 157, such as a present value technique (i.e., an income approach) or the amount the reporting entity would receive if it was to transfer or enter into the identical liability at the measurement date (i.e., a market approach).

The proposed FSP also notes that a quoted price for the identical liability when traded as an asset is considered a Level 1 measurement of fair value unless any adjustments are applied to the quoted price as an asset.¹ Adjustments to quoted prices

may be necessary if the quoted price is not determinative of the fair value of the asset due to a significant decrease in the volume and level of activity for the asset. The recently issued FSP 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*, provides additional guidance on estimating fair value in these instances. Other circumstances that may warrant an adjustment to an asset price when estimating the fair value of a corresponding liability include instances in which the asset traded relates to a similar but not identical liability, and circumstances in which the attributes of the asset differ from the attributes of the liability. Examples of such circumstances include situations in which the asset is subject to transfer restrictions or the asset is subject to a third-party credit enhancements that is not part of the unit of account for the liability (see EITF Issue No. 08-5, "Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement"). Any adjustments to quoted prices render the fair value measurement a lower level.

The proposed FSP reiterates the guidance in Statement 157 that reporting entities should incorporate assumptions that would be used by market participants in estimating the fair value at which a liability would be transferred as of the measurement date. In addition, the fair value measurement of a liability should comply with the principal market and unit-of-account requirements of Statement 157.

The proposed FSP also states that an entity is prohibited from including a separate input or adjustment to other inputs for the existence of a contractual restriction that prevents the transfer of the liability. The FASB believes that the effect of nontransferability was implicitly or explicitly incorporated into the original transaction price of the liability and, therefore, no adjustment for lack of transferability is necessary upon initial or subsequent fair value measurements.

Effective date

The proposed FSP will be effective for the first reporting period (including interim periods) beginning after its issuance, with earlier application permitted. In the period of adoption, entities must disclose any change in valuation technique resulting from the application of the proposed FSP, and quantify its effect, if practicable. Revisions resulting from a change in the valuation technique or its application must be included in changes in fair value in the period of adoption.

¹ Statement 157 provides a disclosure hierarchy for inputs used in fair value measurement based on the degree to which the inputs are observable in the market. Level 1 measurements are based on quoted prices in active markets for identical assets or liabilities. Level 2 measurements are based on significant other observable inputs, and Level 3 measurements are based on significant unobservable inputs.