FINANCIAL ACCOUNTING SERIES

ACCOUNTING STANDARDS UPDATE

No. 2009-05
August 2009

Fair Value Measurements and Disclosures (Topic 820)

Measuring Liabilities at Fair Value

An Amendment of the *FASB Accounting Standards Codification*™

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

Some entities have expressed concern that there may be a lack of observable market information to measure the fair value of a liability. In many cases, an entity would extinguish a liability by settling the obligation directly with the counterparty rather than by paying another entity to assume the existing obligation. In the limited circumstances when an existing liability may be transferred to a new obligor, the transferee may not have the same nonperformance risk as the transferor. Furthermore, some entities question how to measure the fair value of a liability in a hypothetical transaction when a restriction prevents such a transfer. They assert that, unlike an asset for which observable data may simply be limited, there is no observable data available to measure a liability because that liability is restricted from being transferred. Additionally, some liabilities (for example, bonds) are traded in the marketplace as assets. Questions have arisen about whether prices of debt instruments traded as assets represent the fair value of that instrument for the issuer (obligor). Because of these issues, some entities believe that the consistency in the application of *FASB Accounting Standards Codification*™ Topic 820 (Fair Value Measurements and Disclosures) could be improved if the Board were to provide guidance on the fair value measurement of liabilities.

Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to all entities that measure liabilities at fair value within the scope of Topic 820.

What Are the Key Provisions?

This Update provides amendments to Subtopic 820-10, Fair Value Measurements and Disclosures—Overall, for the fair value measurement of liabilities. This Update provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques:

1. A valuation technique that uses:
    a. The quoted price of the identical liability when traded as an asset
    b. Quoted prices for similar liabilities or similar liabilities when traded as assets.
2. Another valuation technique that is consistent with the principles of Topic 820. Two examples would be an income approach, such as a present value technique, or a market approach, such as a technique that is based on the amount at the measurement date that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability.

The amendments in this Update also clarify that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability.

The amendments in this Update also clarify that both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements.

How Are the Key Provisions Different from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The amendments in this Update reduce potential ambiguity in financial reporting when measuring the fair value of liabilities. Therefore, preparers, investors, and other users of financial statements will have a better understanding of how the fair value of liabilities was measured, helping to improve consistency in the application of Topic 820.

When Is the Guidance in This Update Effective?

The guidance provided in this Update is effective for the first reporting period (including interim periods) beginning after issuance.

How Do the Provisions Compare with International Financial Reporting Standards (IFRS)?

Under U.S. GAAP, the fair value of a liability is measured in accordance with the requirements of Topic 820. Under IFRS, the fair value of a liability is measured in accordance with the requirements of the appropriate IFRS. The amendments in this Update do not have an effect on existing IFRS guidance.

Amendments to the *FASB Accounting Standards Codification*™

Introduction

1. The following are amendments to the Accounting Standards Codification as a result of this Update. In some cases, not only are the amended paragraphs shown but the preceding and following paragraphs also are shown to put the change in context. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 820-10

2. Add paragraphs 820-10-35-16A through 35-16G, with a link to transition paragraph 820-10-65-5, as follows:

820-10-35-16A A fair value measurement assumes that a liability is exchanged in an orderly transaction between market participants. However, liabilities are rarely transferred in the marketplace because of contractual or other legal restrictions preventing the transfer of liabilities. Some liabilities (for example, debt obligations), however, are traded in the marketplace as assets.

820-10-35-16B If a quoted price in an active market for the identical liability is available, it represents a Level 1 measurement. In circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity shall measure fair value using one or more of the following techniques:

- a. A valuation technique that uses:
  1. The quoted price of the identical liability when traded as an asset
  2. Quoted prices for similar liabilities or similar liabilities when traded as assets.
- b. Another valuation technique that is consistent with the principles of this Topic. Two examples would be an income approach, such as a present value technique, or a market approach, such as a technique that is based on the amount at the measurement date that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability.

820-10-35-16C In all instances, the reporting entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs. Furthermore, a reporting entity shall apply all applicable guidance in this Topic in determining fair value when the volume and level of activity for an asset or liability have significantly decreased and in identifying transactions that are not orderly.

820-10-35-16D When measuring the fair value of a liability using the quoted price of the liability when traded as an asset, the reporting entity shall not adjust the quoted price of the asset for the effect of a restriction preventing its sale. However, the quoted price of the liability when traded as an asset shall be adjusted for factors specific to the asset that are not applicable to the fair value measurement of the liability. Some circumstances in which a reporting entity shall consider whether the quoted price of the asset should be adjusted include the following:

a. The quoted price for the asset relates to a similar (but not identical) liability traded as an asset.
b. The unit of account for the asset is not the same as for the liability (for example, the quoted price for the asset includes the effect of a third-party credit enhancement). See paragraph 820-10-35-18A for further guidance.

820-10-35-16E When estimating the fair value of a liability, a reporting entity shall not include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability (see paragraphs 820-10-55-71 through 55-76). The effect of a restriction that prevents the transfer of a liability is either implicitly or explicitly already included in the other inputs to the fair value measurement. For example, at the transaction date, both the creditor and the obligor are willing to accept the transaction price for the liability with full knowledge that the obligation includes a restriction that prevents its transfer. As a result of the restriction already being included in the transaction price, a separate input or adjustment to an existing input into the fair value measurement of a liability is not required at the transaction date to reflect the effect of the restriction on transfer. Additionally, a separate input or adjustment to other inputs into the fair value measurement of a liability is not required at subsequent measurement dates to reflect the effect of the restriction on transfer.

820-10-35-16F In addition, there are two fundamental differences between the fair value measurement of an asset and a liability that justify different treatments for asset restrictions and for liability restrictions. First, restrictions on the transfer of a liability relate to performance under the obligation (that is, the reporting entity is legally obligated to satisfy the obligation and needs to do something to be relieved of the obligation), whereas restrictions on the transfer of an asset relate to the marketability of the asset. Second, virtually all liabilities include a restriction preventing the transfer of the liability, whereas most assets do not include a similar restriction. As a result, the effect of a restriction preventing the transfer of a liability would, theoretically, be consistent for all liabilities. However, the inclusion of a restriction preventing the sale of the asset typically results in a lower fair value for the restricted asset versus the nonrestricted asset, all other factors being equal.

820-10-35-16G When measuring the fair value of a liability using a valuation technique, a reporting entity shall ensure that the fair value measurement is consistent with the principles of this Topic, that is, the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. For example, when using a technique based on the amount at the measurement date that the reporting entity would receive to enter into the identical liability (see paragraph 820-10-35-16B), the inputs shall reflect the assumptions that market participants would use (or the reporting entity's own assumption about the assumptions that market participants would use) in the principal or most advantageous market for issuance of a liability with the same contractual terms.

3. Amend paragraph 820-10-35-41**,** with a link to transition paragraph 820-10-65-5, as follows:

820-10-35-41 A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in ~~the following~~ paragraphs 820-10-35-16D, 820-10-35-42, and ~~paragraph~~ 820-10-35-43.

4. Add paragraph 820-10-35-41A, with a link to transition paragraph 820-10-65-5, as follows:

820-10-35-41A A Level 1 fair value measurement for the liability is a quoted price in an active market for the identical liability at the measurement date. In addition, the quoted price for the identical liability when traded as an asset in an active market also is a Level 1 fair value measurement for that liability when no adjustments to the quoted price of the asset are required. However, a reporting entity needs to determine whether the quoted price for the identical liability when traded as an asset in an active market should be adjusted for factors specific to the liability and the asset (see paragraph 820-10-35-16D). Any adjustment to the quoted price of the asset shall render the fair value measurement of the liability a lower level measurement.

5. Amend paragraph 820-10-35-50**,** with a link to transition paragraph 820-10-65-5, as follows:

820-10-35-50 Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the following:

a. The condition and/or location of the asset or liability
b. The extent to which the inputs relate to items that are comparable to the asset or liability, including those factors discussed in paragraph 820-10-35-16D
c. The volume and level of activity in the markets within which the inputs are observed.

6. Add paragraphs 820-10-55-65 through 55-76 and related headings**,** with a link to transition paragraph 820-10-65-5, as follows:

> > Example 9: Measuring Liabilities

820-10-55-65 The following Cases illustrate the measurement of liabilities:

a. Asset Retirement Obligation (Case A)
b. Debt Obligation: Quoted Price (Case B)
c. Debt Obligation: Present Value Technique (Case C).

> > > Case A: Asset Retirement Obligation

820-10-55-66 On January 1, 20X1, Entity A completes construction of and places into service an offshore oil platform. The entity is legally required to dismantle and remove the platform at the end of its useful life, which is estimated to be 10 years. According to the guidance in paragraph 410-20-25-4, the entity is required to recognize, at fair value, an asset retirement obligation.

820-10-55-67 On the basis of the guidance in paragraph 410-20-30-1, Entity A uses the expected present value technique to measure the fair value of the asset retirement obligation.

820-10-55-68 If Entity A was contractually allowed to transfer its asset retirement obligation to a market participant, Entity A believes a market participant would use all of the following inputs, probability-weighted as appropriate, in determining the price it would expect to receive:

a. Labor costs
b. Allocation of overhead costs
c. Profit on labor and overhead costs
d. Effect of inflation on estimated costs and profits
e. Risk premium for bearing the uncertainty inherent in cash flows, other than inflation
f. Time value of money, represented by the risk-free rate
g. Nonperformance risk relating to the liability, including Entity A's own credit risk.

820-10-55-69 The significant assumptions used in Entity A's estimate of fair value are as follows:

a. Labor costs are based on current marketplace wages required to hire contractors to dismantle and remove offshore oil platforms. Entity A assigns probability assessments to a range of cash flow estimates as follows.

Cash Flow Estimate	**Probability Assessment**	**Expected Cash Flows**
$ 100,000	25%	$ 25,000
$ 125,000	50%	62,500
$ 175,000	25%	43,750
		$ 131,250

The probability assessments are based on Entity A's experience with fulfilling obligations of this type and its knowledge of the market.

b. Entity A estimates allocated overhead and equipment operating costs using the rate it applies to labor costs (80 percent of expected labor costs). This is consistent with the cost structure of market participants.

c. A contractor typically adds a markup on labor and allocated internal costs to provide a profit margin on the job. The profit margin used (20 percent) represents Entity A's understanding of the operating profit that contractors in the industry generally earn to dismantle and remove offshore oil platforms. Entity A believes this rate is consistent with the rate a market participant would demand as a return for bearing the obligation.

d. Entity A assumes a rate of inflation of 4 percent over the 10-year period on the basis of available market data.

e. A contractor would typically demand and receive a premium (market risk premium) for bearing the uncertainty inherent in locking in today's price for a project that will not occur for 10 years. Entity A estimates the amount of that premium to be 5 percent of the expected cash flows, adjusted for inflation.

f. The risk-free rate of interest for a 10-year maturity on January 1, 20X1, is 5 percent. Entity A adjusts that rate by 3.5 percent to reflect its risk of nonperformance. Therefore, the discount rate used to compute the present value of the cash flows is 8.5 percent.

820-10-55-70 Entity A believes that its assumptions would be used by market participants. In addition, Entity A does not adjust its fair value measurement for the existence of a restriction preventing it from transferring the liability. As illustrated in the following table, Entity A estimates the fair value of its liability for the asset retirement obligation to be $194,879.

		Expected Cash Flows 1/1/X1
Expected labor costs	$	131,250
Allocated overhead and equipment costs (.80 x $131,250)	$	105,000
Contractor's profit markup [.20 x ($131,250 + $105,000)]	$	47,250
Expected cash flows before inflation adjustment	$	283,500
Inflation factor (4% for 10 years)		1.4802
Expected cash flows adjusted for inflation	$	419,637
Market-risk premium (.05 x $419,637)	$	20,982
Expected cash flows adjusted for market risk	$	440,619
Expected present value using discount rate of 8.5% for 10 years	$	194,879

> > > Case B: Debt Obligation: Quoted Price

820-10-55-71 On January 1, 20X1, Entity B issues at par a $2 million BBB-rated exchange-traded 5-year fixed-rate debt instrument with an annual 10 percent interest coupon. Entity B has elected to account for this instrument under the fair value option.

820-10-55-72 On December 31, 20X1, the instrument is trading as an asset in an active market at $929 per $1,000 of par value after payment of accrued interest. Entity B uses the quoted price for the asset in an active market as its initial input into the fair value measurement of its liability ($929 × [$2 million ÷ $1,000] = $1,858,000). In determining whether the quoted price for the asset in an active market represents the fair value of the liability, Entity B evaluates whether the quoted price for the asset includes the effect of factors not applicable to the fair value measurement of a liability, for example, whether the quoted price for the asset includes the effect of third-party credit enhancements. Entity B determines that no adjustments are required to the quoted price of the asset. Accordingly, Entity B concludes that the fair value of its debt instrument at December 31, 20X1, is $1,858,000. Entity B categorizes and discloses the fair value measurement of its debt instrument as a Level 1 measurement.

> > > Case C: Debt Obligation: Present Value Technique

820-10-55-73 On January 1, 20X1, Entity C issues at par in a private placement a $2 million BBB-rated 5-year fixed-rate debt instrument with an annual 10 percent interest coupon. Entity C has elected to account for this instrument under the fair value option.

820-10-55-74 At December 31, 20X1, Entity C still carries a BBB credit rating. Market conditions, including available interest rates, credit spreads for a BBB-quality credit rating and liquidity, remain unchanged from the issuance date of the debt instrument. However, Entity C's credit spread has deteriorated by 50 basis points due to a change in its risk of nonperformance. After considering all market conditions, Entity C concludes that if it was to issue the instrument at the measurement date, the instrument would bear a rate of interest of 10.5 percent or Entity C would receive less than par in proceeds from the issuance of the instrument.

820-10-55-75 For the purpose of this example, the fair value of Entity C's liability is calculated using a present value technique. Entity C believes a market participant would use all of the following inputs (consistent with paragraph 820-10-55-5) in determining the price the market participant would expect to receive to assume Entity C's obligation:

a. Terms of the debt instrument, including all of the following:
   1. Coupon interest rate of 10 percent
   2. Principal amount of $2 million
   3. Term of 4 years.
b. Change in risk of nonperformance from the date of issuance of 50 basis points.

820-10-55-76 On the basis of its present value technique, Entity C concludes that the fair value of its liability at December 31, 20X1, is $1,968,641. Entity C does not include any additional input into its present value technique for risk or profit that a market participant might require for compensation for assuming the liability. Because Entity C's obligation is a financial liability, Entity C believes the interest rate already captures the risk or profit that a market participant would require for compensation for assuming the liability. Furthermore, Entity C does not adjust its present value technique for the existence of a restriction preventing it from transferring the liability.

7. Add paragraph 820-10-65-5 and related heading as follows:

> Transition Related to Accounting Standards Update 2009-05, Measuring Liabilities under Topic 820

820-10-65-5 The following represents the transition and effective date information related to Accounting Standards Update **2009-05:**

a. The pending content that links to this paragraph shall be effective for the first reporting period, including interim periods, beginning after issuance.
b. Early application is permitted if financial statements for prior periods have not been issued.
c. Revisions resulting from a change in valuation technique or its application shall be accounted for as a change in accounting estimate (see the guidance beginning in paragraph 250-10-45-17).

d. <u>In the period of adoption, a reporting entity shall disclose a change, if any, in valuation technique and related inputs resulting from the application of the pending content that links to this paragraph, and quantify the total effect, if practicable.</u>

Amendment to Subtopic 825-10

8. Amend paragraph 825-10-55-3, with a link to transition paragraph 820-10-65-5, as follows:

825-10-55-3 Bank A might disclose the following.

Note V: Disclosures about Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and short-term investments. For those short-term instruments, the carrying amount is a reasonable estimate of fair value.

Investment securities and trading account assets. For securities and derivative instruments held for trading purposes (which include bonds, interest rate futures, options, interest rate swaps, securities sold not owned, caps and floors, foreign currency contracts, and forward contracts) and marketable equity securities held for investment purposes, fair values are based on quoted market prices or dealer quotes. For other securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loan receivables. For certain homogeneous categories of loans, such as some residential mortgages, credit card receivables, and other consumer loans, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Deposit liabilities. The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

Long-term debt. Rates currently available to the Bank for debt with similar terms and remaining maturities are used to estimate fair value of existing debt. Fair value of long-term debt is based on quoted market prices or dealer quotes for the identical liability when traded as an asset in an active market. If a quoted market price is not available, an expected present value technique is used to estimate fair value.

[For ease of use, the existing guidance for this paragraph, which is unaffected by this Update, has been omitted.]

Status Section

9. Amend paragraph 820-10-00-1 as follows:

Paragraph Number	Action	Accounting Standards Update	Date
820-10-35-16A	Added	2009-05	08/26/2009
820-10-35-16B	Added	2009-05	08/26/2009
820-10-35-16C	Added	2009-05	08/26/2009
820-10-35-16D	Added	2009-05	08/26/2009
820-10-35-16E	Added	2009-05	08/26/2009
820-10-35-16F	Added	2009-05	08/26/2009
820-10-35-16G	Added	2009-05	08/26/2009
820-10-35-41	Amended	2009-05	08/26/2009
820-10-35-41A	Added	2009-05	08/26/2009
820-10-35-50	Amended	2009-05	08/26/2009
820-10-55-65	Added	2009-05	08/26/2009
820-10-55-66	Added	2009-05	08/26/2009
820-10-55-67	Added	2009-05	08/26/2009
820-10-55-68	Added	2009-05	08/26/2009
820-10-55-69	Added	2009-05	08/26/2009
820-10-55-70	Added	2009-05	08/26/2009
820-10-55-71	Added	2009-05	08/26/2009
820-10-55-72	Added	2009-05	08/26/2009
820-10-55-73	Added	2009-05	08/26/2009
820-10-55-74	Added	2009-05	08/26/2009
820-10-55-75	Added	2009-05	08/26/2009
820-10-55-76	Added	2009-05	08/26/2009
820-10-65-5	Added	2009-05	08/26/2009

10. Amend paragraph 825-10-00-1 as follows:

Paragraph Number	Action	Accounting Standards Update	Date
825-10-55-3	Amended	2009-05	08/26/2009

The amendments in this Accounting Standards Update were adopted by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

Amendments to the XBRL Taxonomy

The following elements should be added to the XBRL taxonomy as a result of the amendments in this Update.

Standard Label	**Definition**	**Codification Reference**	**Taxonomy Reference**
Fair Value, Liabilities Measured on Recurring Basis, Debt Instrument, Valuation Technique	This element represents the inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.	820-10-65-5 820-10-50-2	460000
Fair Value, Liabilities Measured on Recurring Basis, Debt Instrument, Qualification of Change in Valuation Techniques	The effect of the change in valuation techniques and related inputs.	820-10-65-5	460000