

Heads Up

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Is Fair Value Changing?

FASB and IASB Issue Substantially Converged Requirements for Fair Value Measurement and Disclosure

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Yesterday, the FASB issued [ASU 2011-04](#).¹ The ASU is the result of joint efforts by the FASB and IASB (the "boards") to develop a single, converged fair value framework — that is, converged guidance on how (not when) to measure fair value and on what disclosures to provide about fair value measurements. Thus, there are few differences between the ASU and its international counterpart, IFRS 13.² (For more information about the differences between the two standards, see [Appendix A](#).)

The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (contained in ASC 820³). For example, the ASU continues to define fair value as an exit price.⁴ However, the ASU expands ASC 820's existing disclosure requirements for fair value measurements and makes other amendments.

Many of the amendments to ASC 820 are being made to eliminate unnecessary wording differences between U.S. GAAP and IFRSs. However, some of the amendments could change how the fair value measurement guidance in ASC 820 is applied. The following is a list of some of the ASU's more noteworthy amendments to the fair value measurement guidance and new disclosure requirements:

- *Highest and best use and valuation premise for nonfinancial assets* — The ASU indicates that the highest-and-best-use and valuation-premise concepts only apply to measuring the fair value of nonfinancial assets.
- *Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk* — The ASU permits an exception to fair value measurement principles for financial assets and financial liabilities (and derivatives) with offsetting positions in market risks or counterparty credit risk when several criteria are met. When the criteria are met, an entity can measure the fair value of the net risk position.

¹ FASB Accounting Standards Update No. 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.

² IFRS 13, *Fair Value Measurement*.

³ For titles of *FASB Accounting Standards Codification* (ASC or "Codification") references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#)."

⁴ ASC 820-10-20 defines "exit price" as the "price that would be received to sell an asset or paid to transfer a liability."

- *Premiums or discounts in fair value measurement* — The ASU states that “[p]remiums or discounts that reflect size as a characteristic of the reporting entity’s holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market’s normal daily trading volume is not sufficient to absorb the quantity held by the entity . . .) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement.”
- *Fair value of an instrument classified in a reporting entity’s shareholders’ equity* — The ASU prescribes a model for measuring the fair value of an instrument classified in shareholders’ equity; this model is consistent with the guidance on measuring the fair value of liabilities.
- *Disclosures about fair value measurements* — The ASU expands ASC 820’s disclosure requirements, particularly for Level 3 inputs. Required disclosures include:
 - For fair value measurements categorized in Level 3 of the fair value hierarchy: (1) a quantitative disclosure of the unobservable inputs and assumptions used in the measurement, (2) a description of the valuation processes in place (e.g., how the entity decides its valuation policies and procedures, as well as changes in its analyses of fair value measurements, from period to period), and (3) a narrative description of the sensitivity of the fair value to changes in unobservable inputs and interrelationships between those inputs.
 - The level in the fair value hierarchy of items that are not measured at fair value in the statement of financial position but whose fair value must be disclosed.

Each of these provisions is summarized in greater detail below.

The ASU is effective for interim and annual periods beginning after December 15, 2011, for public entities and for annual periods beginning after December 15, 2011, for nonpublic entities (see the [Effective Date and Transition](#) section below).

Highest and Best Use and Valuation Premise for Nonfinancial Assets

The ASU clarifies that the highest-and-best-use and valuation-premise concepts only apply to measuring the fair value of nonfinancial assets. The boards concluded that financial assets and liabilities “do not have alternative uses.”

Although now limited to nonfinancial assets as a result of the ASU’s amendments, the highest-and-best-use concept remains substantially the same. This concept dictates that fair value measurements take into account a market participant’s ability to generate economic benefits by (1) employing the asset at its highest and best use or (2) selling the asset to another market participant that would employ the asset at its highest and best use. The highest and best use of a nonfinancial asset is one that is physically possible, legally permissible, and financially feasible.

The ASU also eliminates from ASC 820 the use of the terms “in-exchange” and “in-use” to describe the valuation-premise concept because the wording was often confusing to constituents. Instead, the valuation-premise guidance indicates more plainly that the highest and best use of a nonfinancial asset is either on a stand-alone basis or in combination with other assets as a group or with other assets and liabilities (e.g., liabilities that fund working capital).

Application to Financial Assets and Financial Liabilities With Offsetting Positions in Market Risks or Counterparty Credit Risk

Under the ASU, there is an exception to the basic fair value measurement principles for a reporting entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity's net exposure to either of those risks. This exception allows the reporting entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position.

Editor's Note: A reporting entity should assess whether the market risks being offset are "substantially the same." Factors to consider in this determination include whether (1) offsetting the group of assets and liabilities would mitigate the entity's risk exposure to a particular market risk and (2) the group of assets and liabilities reflects the entity's exposure to the particular risk for a particular duration. For instance, ASC 820-10-35-18J (added by the ASU) states that "a reporting entity would not combine the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability because doing so would not mitigate the reporting entity's exposure to interest rate risk or commodity price risk." In addition, ASC 820-10-35-18K (also added by the ASU) indicates that "a reporting entity that uses a 12-month futures contract against the cash flows associated with 12 months' worth of interest rate risk exposure on a 5-year financial instrument within a group made up of only those financial assets and financial liabilities measures the fair value of the exposure to 12-month interest rate risk on a net basis and the remaining interest rate risk exposure (that is, years 2 through 5) on a gross basis."

To use the exception, an entity must meet all of the following conditions (reprinted from the ASU):

- a. Manages the group of financial assets and financial liabilities on the basis of the reporting entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the reporting entity's documented risk management or investment strategy.
- b. Provides information on that basis about the group of financial assets and financial liabilities to the reporting entity's **management**.
- c. Is required or has elected to measure those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.

The ASU also describes how an entity should evaluate when to include the effect of the entity's net exposure to the credit risk of that counterparty (or the counterparty's net exposure to the credit risk of the entity) in the fair value measurement. The ASU indicates that the effect should be included "when market participants would take into account any existing arrangements that mitigate credit risk exposure in the event of default (for example, a master netting agreement with the counterparty or an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party)." The ASU further clarifies that in such cases "[t]he fair value measurement shall reflect market participants' expectations about the likelihood that such an arrangement would be legally enforceable in the event of default."

Editor's Note: The ability to consider the fair value measurement of a portfolio of financial assets and financial liabilities on the basis of net exposure does not affect the basis of financial statement presentation for these instruments. A reporting entity must comply with the financial statement presentation requirements of other ASC topics (e.g., ASC 210-20). The FASB and IASB are currently working on converging their accounting standards on the offsetting of financial assets and financial liabilities, since differences between U.S. GAAP and IFRSs in this area have resulted in significant differences in balance sheet presentation. See Deloitte's February 2, 2011, *Heads Up* for more information.

Premiums and Discounts in Fair Value Measurement

The ASU provides a framework for considering whether a premium or discount can be applied in a fair value measurement. The framework contains the following key principles (from the ASU):

- “A reporting entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability In some cases, those characteristics result in the application of an adjustment, such as a premium or discount (for example, a control premium or noncontrolling interest discount).”
- “A fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the Topic that requires or permits the fair value measurement.”

Editor’s Note: The boards maintained their stance that unit-of-account guidance is outside the scope of the fair value measurement project. That is, the guidance in ASC 820 will continue to focus on how to measure fair value, not what is being measured at fair value or when an asset or liability should be measured at fair value. Constituents would therefore continue to look to other ASC topics for unit-of-account guidance (e.g., the guidance in ASC 350 on reporting units).

- “Premiums or discounts that reflect size as a characteristic of the reporting entity’s holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market’s normal daily trading volume is not sufficient to absorb the quantity held by the entity . . .) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement.”

Editor’s Note: When an entity concludes, upon evaluating the unit-of-account guidance in an ASC topic, that the unit of account is not the entire holding, it may not adjust the fair value for characteristics that are specific to the size of the entire holding (such as a blockage factor); however, it is not precluded from considering adjustments to fair value that are relevant to the unit of account (such as market liquidity or restrictions on sale).

- “[I]f there is a quoted price in an active market (that is, a Level 1 input) for an asset or a liability, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C.”

Fair Value of an Instrument Classified in a Reporting Entity’s Shareholders’ Equity

ASC 820 did not previously provide guidance on measuring the fair value of an instrument classified in shareholders’ equity (e.g., equity interests related to a business combination). The ASU fills this void, specifying that a reporting entity should assume that in determining the fair value of the equity-classified instrument, it is not canceled but instead transferred to a market participant who would take on the “rights and responsibilities associated with the instrument” on the measurement date. The fair value of an instrument classified in a reporting entity’s shareholders’ equity is estimated “from the perspective of a **market participant that holds the identical item as an asset**” (emphasis added). The ASU lays out a model for measuring the fair value of an instrument classified in shareholders’ equity; this model is consistent with the guidance on measuring the fair value of liabilities.

Disclosures About Fair Value Measurements

Unlike the exposure draft (ED), the final ASU does not require quantitative measurement uncertainty analysis disclosures.

Editor’s Note: The FASB decided not to include in the final standard the ED’s proposal that would have required reporting entities to provide a quantitative measurement uncertainty disclosure for Level 3 recurring fair value measurements. This disclosure would have been in the form of a quantitative sensitivity analysis of unobservable inputs to reasonable alternative amounts. The proposed disclosure would have also required reporting entities to take into account the effect of correlation between unobservable inputs if such correlation was relevant to estimating the effect on the fair value measurement. The FASB expects to revisit this potential disclosure requirement as part of a separate project.

However, the ASU does expand the qualitative and quantitative fair value disclosure requirements. For fair value measurements categorized in Level 3 of the fair value hierarchy, the standard requires (1) a description of the valuation processes in place (e.g., how the entity decides its valuation policies and procedures, as well as its analyses of changes in fair value measurements, from period to period) and (2) a narrative description of the sensitivity of the fair value to changes in unobservable inputs and interrelationships between those inputs if a change in those inputs would result in a significantly different fair value measurement.

The ASU also requires a reporting entity to provide quantitative disclosures about unobservable inputs used in a Level 3 fair value measurement (see [Appendix B](#) for an example of quantitative disclosures). An entity is not required to create quantitative information to comply with this disclosure requirement if the entity does not develop quantitative unobservable inputs when measuring fair value. The ASU cites the use of prices from prior transactions or third-party pricing information without adjustment as examples of situations in which quantitative unobservable inputs may not be developed by a reporting entity when measuring fair value. The ASU adds, however, that an entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the entity.

Editor’s Note: Reporting entities that use net asset value as a practical expedient to determine the fair value of investments are not required to provide quantitative disclosures about unobservable inputs and assumptions for those investments even though they may be Level 3 fair value measurements. The FASB indicated in paragraph BC89 of the Basis for Conclusions of the ASU that “disclosures about the fair value of those assets and liabilities that are subject to the practical expedient and categorized within Level 3 of the fair value hierarchy would not be meaningful for such instruments because the determination of the level in the hierarchy is made on the basis of the reporting entity’s ability to redeem its investment, rather than on the basis of whether the inputs used in the measurement are observable or unobservable.”

In addition, the ASU requires disclosures about:

- The highest and best use of a nonfinancial asset when this use differs from the asset’s current use. The reporting entity should also disclose the reason for such a difference.
- For transfers between levels, ASU 2010-06⁵ amended ASC 820 to require disclosures about **significant** transfers between Level 1 and Level 2 of the fair value hierarchy. The ASU amends the disclosure requirement to include **any** transfers between Level 1 and Level 2.

⁵ FASB Accounting Standards Update No. 2010-06, *Improving Disclosures About Fair Value Measurements*.

- Disclosure of fair value by level for each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed. For example, ASC 825 requires disclosure of the fair value of certain financial instruments (e.g., loans) even though such instruments may be recognized at amortized cost in the statement of financial position. Under the new disclosure requirement, a reporting entity would be required to disclose the instrument's level within the fair value hierarchy.

Nonpublic Entities

The FASB considered whether the amendments to ASC 820 should apply to nonpublic entities and decided not to exempt nonpublic entities from any of the fair value measurement principles. However, nonpublic entities will be exempt from certain disclosure requirements. Nonpublic entities will not be required to disclose the following:

- The information required for public companies when fair value is disclosed but not recognized in the financial statements, except if required by another ASC Topic.
- A qualitative discussion of the sensitivity of the fair value to changes in unobservable inputs and the interrelationships between those inputs.
- Transfers between Levels 1 and 2 of the fair value hierarchy.

Editor's Note: The following definition of "nonpublic entity" from the Codification glossary applies to the ASU:

Any entity that does not meet any of the following conditions:

- Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.
- It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
- It is required to file or furnish financial statements with the Securities and Exchange Commission.
- It is controlled by an entity covered by criteria (a) through (d).

Effective Date and Transition

The ASU's measurement and disclosure requirements are effective for **public entities** for reporting periods (including interim periods) **beginning after** December 15, 2011 (i.e., for calendar-year entities, the beginning of first quarter ended March 31, 2012), and for **nonpublic entities** for annual periods **beginning after** December 15, 2011. Nonpublic entities may early adopt the amendments for interim periods beginning after December 15, 2011.

The amendments in the ASU should be applied prospectively (i.e., no cumulative adjustment to opening retained earnings). Entities should disclose the change, if any, in valuation technique and related inputs resulting from application of the amendments and should quantify and disclose the total effect of the change, if practicable.

Appendix A — Convergence With IFRS 13

The fair value measurement and disclosure requirements in IFRS 13 are nearly identical to those in the ASU, with a few exceptions, including the following:

- Certain style differences that are not expected to result in inconsistent application (e.g., differences in spelling and differences in references to other U.S. GAAP and IFRSs).
- Differences related to the U.S. GAAP guidance on net asset value per share. This guidance provides a practical expedient that, under certain circumstances, permits an entity to measure the fair value of investments in certain entities that apply investment-company accounting on the basis of net asset value per share. The IASB is not including this guidance in IFRSs because there are no equivalent investment-company accounting requirements under IFRSs.
- Differences in disclosure requirements, including the following:
 - Amounts disclosed in Level 3 of the fair value hierarchy under IFRSs may differ from those disclosed under U.S. GAAP because the offsetting requirements for financial instruments differ. Currently, the boards are working to converge their accounting standards on the offsetting of financial assets and liabilities to address these quantitative presentation differences.
 - Quantitative measurement uncertainty analysis is required under IFRSs for financial instruments measured at fair value and categorized in Level 3 of the fair value hierarchy.
 - Nonpublic entities are exempt from certain fair value disclosure requirements under U.S. GAAP (see the [Nonpublic Entities](#) section). Under IFRSs, there is no similar exclusion.
- Differences in the recognition of day-one gains or losses that arise when the initial fair value of an asset or liability differs from the transaction price. For example, under IFRS 9⁶ and IAS 39,⁷ gains and losses related to unobservable market data are precluded from immediate recognition. Under U.S. GAAP, there is no similar prohibition.
- Potential for differences in how the fair value of a deposit liability is measured. ASC 825 and 942 specify that the fair value of a deposit liability is the amount payable on demand as of the reporting date. IFRS 13 indicates that the fair value of a demand deposit cannot be less than the present value of the amount payable on demand.

⁶ IFRS 9, *Financial Instruments*.

⁷ IAS 39, *Financial Instruments: Recognition and Measurement*.

Appendix B — Quantitative Information Regarding Disclosures About Level 3 Fair Value Measurements

The following table (reprinted from the ASU) illustrates the requirement to disclose information about quantitative inputs and assumptions for items categorized in Level 3 of the fair value hierarchy:

Quantitative Information About Level 3 Fair Value Measurements					
(\$ in millions)	Fair Value at 12/31/X9	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)	
Residential mortgage-backed securities	125	Discounted cash flow	Constant prepayment rate	3.5% – 5.5% (4.5%)	
			Probability of default	5% – 50% (10%)	
			Loss severity	40% – 100% (60%)	
Commercial mortgage-backed securities	50	Discounted cash flow	Constant prepayment rate	3.0% – 5.0% (4.1%)	
			Probability of default	2% – 25% (5%)	
			Loss severity	10% – 50% (20%)	
Collateralized debt obligations	35	Consensus pricing	Offered quotes	20 – 45	
			Comparability adjustments (%)	-10% – +15% (+5%)	
Direct venture capital investments: healthcare	53	Discounted cash flow	Weighted average cost of capital	7% – 16% (12.1%)	
			Long-term revenue growth rate	2% – 5% (4.2%)	
			Long-term pretax operating margin	3% – 20% (10.3%)	
			Discount for lack of marketability ^(a)	5% – 20% (17%)	
			Control premium ^(a)	10% – 30% (20%)	
			Market comparable companies	EBITDA multiple ^(b)	10 – 13 (11.3)
				Revenue multiple ^(b)	1.5 – 2.0 (1.7)
				Discount for lack of marketability ^(a)	5% – 20% (17%)
				Control premium ^(a)	10% – 30% (20%)
		Direct venture capital investments: energy	32	Discounted cash flow	Weighted average cost of capital
Long-term revenue growth rate	3% – 5.5% (4.2%)				
Long-term pretax operating margin	7.5% – 13% (9.2%)				
Discount for lack of marketability ^(a)	5% – 20% (10%)				
Control premium ^(a)	10% – 20% (12%)				
	Market comparable companies			EBITDA multiple ^(b)	6.5 – 12 (9.5)
				Revenue multiple ^(b)	1.0 – 3.0 (2.0)
				Discount for lack of marketability ^(a)	5% – 20% (10%)
				Control premium ^(a)	10% – 20% (12%)
Credit contracts	38			Option model	Annualized volatility of credit ^(c)
		Counterparty credit risk ^(d)	0.5% – 3.5%		
		Own credit risk ^(d)	0.3% – 2.0%		

^(a) Represents amounts used when the reporting entity has determined that market participants would take into account these premiums and discounts when pricing the investments.

^(b) Represents amounts used when the reporting entity has determined that market participants would use such multiples when pricing the investments.

^(c) Represents the range of the volatility curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.

^(d) Represents the range of the credit default swap spread curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.

The FASB indicated in paragraph BC87 of the ASU that the purpose of the information in this disclosure is not to provide financial statement users the level of information that would be necessary to “replicate the reporting entity’s pricing models, but to provide enough information for users to assess whether the reporting entity’s views about individual inputs differed from their own and, if so, to decide how to incorporate the reporting entity’s fair value measurement in their decisions.”

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