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Another Step Along the Path to Transparency

New disclosure requirements from the FASB are intended to provide financial-statement users with greater transparency about the way reporting entities apply the fair value measurement provisions of U.S. GAAP.

Few accounting issues have generated as much controversy as the use of fair value measurements, which are in some cases required and in other cases permitted under U.S. Generally Accepted Accounting Principles (GAAP). Although fair value has been vilified in many circles, the Financial Accounting Standards Board (FASB) has found ample support for it from investors and other users of financial statements. Even so, the FASB has identified and acted on several opportunities to improve the disclosure provisions of U.S. GAAP that relate to fair value measurements. In this month's column, I'll describe recent changes to those provisions and look ahead to an additional change that the FASB is considering.

Transparency through Disclosure

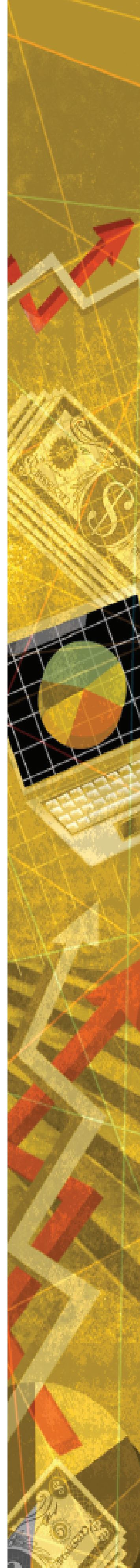
Conceptually, the measurement of fair value under U.S. GAAP is straightforward. FASB *Accounting Standards Codification*™ (ASC) Topic 820, *Fair Value Measurements and Disclosures*, states that fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Complications arise, though, when reporting entities go to apply this concept in practice.

The dominant fair value measurement approach under U.S. GAAP is based on a three-level hierarchy of methods. The measurement method that must be applied to a particular asset or liability as of a particular point in time depends on what information is or isn't available to the reporting entity. Level 1 measurements are considered the most reliable because they're based on objective, observable market information. For example, for a financial instrument traded in an orderly market, actual transaction prices would form the basis for a Level 1 fair value measurement. Of course, Level 1 information isn't available for all assets and liabilities under all circumstances, so reporting entities are often forced to use less-objective and/or less-observable information in measuring fair value. Ultimately, Level 3 is the fallback—a reporting entity can always produce subjective, unobservable information out of thin air if better information isn't available for use in measuring fair value.

Although investors and other users of financial statements generally embrace the relevance of fair value measurements as currently required or permitted under U.S. GAAP and respect the practical necessity of the three-level measurement-method hierarchy, users have expressed concern regarding the diversity of fair value measurement methods across entities, over time, and among assets and liabilities on the same balance sheet. The FASB has attempted to address the concerns of financial-statement users by requiring reporting entities to disclose how different fair value measurement methods are applied to different items on the balance sheet. In other words, the FASB has attempted to make the application of the three-level measurement-method hierarchy more transparent to users of financial statements through meaningful disclosures.

Better Disclosures

At its May 28, 2009, meeting, the FASB discussed a project to



improve fair value disclosure requirements and tentatively proposed several aspects of an improved fair value disclosure model. Three months later, the Board published an Exposure Draft (ED) of a proposed Accounting Standards Update (ASU), "Improving Disclosures about Fair Value Measurements." The ED proposed clarifications to existing disclosures about fair value measurements as well as additional new disclosures.

After further deliberations and a few significant modifications to what it had proposed in the ED, the FASB issued final ASU No. 2010-06, "Improving Disclosures about Fair Value Measurements," on January 21, 2010. The amendments to ASC 820 that are detailed in ASU No. 2010-06 apply to all entities that are required to make disclosures about recurring or nonrecurring fair value measurements under U.S. GAAP.

Like the ED that preceded it, ASU No. 2010-06 clarifies two existing disclosure requirements. In the first case, the FASB had observed that reporting entities often didn't provide as much detail in their fair value measurement disclosures as the Board had originally intended. Therefore, the ASU specifies that entities will be required to provide fair value measurement disclosures for each class of assets and liabilities, with classes generally being more detailed than the line items of a reporting entity's balance sheet. The ASU further specifies that classes for fair value measurement disclosures should be determined on the basis of the nature and risks of assets and liabilities and their level (1, 2, or 3) in the fair value measurement hierarchy. For equity and debt securities, a class is the same as a major security type as defined elsewhere in the Codification. For all other assets and liabilities, management is expected to exercise judgment in determining the appropriate classes for which to provide disclosures about fair value measurements.

The second clarification in ASU No. 2010-06 directs reporting entities to provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements that fall in either Level 2 or Level 3 of the measurement-method hierarchy.

More Disclosures

ASU No. 2010-06 also introduces two new disclosure requirements. First, a reporting entity must now disclose the amounts of "significant" transfers into and/or out of Level 1 and Level 2 fair value measurements and the reasons for the transfers. In other words, as more- or less-reliable market information becomes available to a reporting entity, the entity may shift its measurement method for a particular asset or liability from one level to another during a reporting period.

The second new disclosure requirement in ASU No. 2010-06 applies to "rollforwards" of fair value measurements that are based on Level 3 information. Such rollforwards explain changes in the dollar amounts of assets and liabilities measured at Level 3 during the reporting period, thus reconciling beginning-of-period figures to end-of-period figures. Specifically, the ASU stipulates that a reporting entity must present information about Level 3 activity (i.e., purchases, sales, issuances, and settlements of assets and liabilities measured at Level 3) on a gross basis rather than as one net number.

The new disclosures and clarifications of existing disclosures are effective for both interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 activity disclosures, which are effective only for annual reporting periods beginning after December 15, 2009. Early adoption is permitted in all cases, and, upon adoption, reporting entities need not make the disclosures for earlier periods that are presented for comparative purposes.

What the Future Holds

In its 2009 ED, the FASB had proposed requiring reporting entities to disclose information about the "sensitivity" of certain Level 3 fair value measurements. In other words, the Board thought it would be a good idea for reporting entities to describe the range of fair values that might have been reported if the entity had used "reasonably possible alternative inputs" for Level 3 measurements and the use of those inputs would have had a significant impact on the fair value measurements. For example, for residential-mortgage-backed securities measured at Level 3, the reporting entity's disclosures might describe how different assumptions about

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discount rates, probabilities of default, loss severity, and prepayments by borrowers would have affected the reported fair values of such securities.

Much to the relief of financial-statement preparers, the FASB decided at its November 11, 2009, meeting to exclude the Level 3 sensitivity disclosures from the final ASU. But the Board plans to reconsider Level 3 sensitivity disclosure requirements as part of the fair value measurement project it's conducting jointly with the International Accounting Standards Board (IASB).

In ASU No. 2010-06, the FASB states that it "concluded that users [of financial statements] will benefit from improved disclosures in this Update and that the benefits of the increased transparency in financial reporting will outweigh the costs of complying with the new requirements." Time will tell whether financial-statement users agree with the Board's assessment. In any case, the FASB is already thinking ahead about its next steps toward improving transparency in fair value measurement. **SF**

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