Recent Significant Developments in Fair Value Accounting

This memorandum discusses four recent significant developments relating to Accounting Standards Codification ("ASC") Topic 820, *Fair Value Measurements and Disclosures*,[1] including:

- The September 30, 2009 issuance of final Accounting Standards Update ("ASU") No. 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*,[2] which amends ASC Subtopic 820-10 to provide guidance for estimating the fair value of certain "alternative investments," such as investments in hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles and funds of funds;[3]

- The August 28, 2009 issuance of final ASU No. 2009-05, *Measuring Liabilities at Fair Value*, which amends ASC Subtopic 820-10 to provide guidance for estimating the fair value of liabilities;[4]

- The August 28, 2009 issuance of an Exposure Draft ("ED") of a proposed Accounting Standards Update ("ASU") called *Improving Disclosures about Fair Value Measurements*, which would amend ASC Subtopic 820-10, to both (i) clarify certain existing required disclosures about fair value measurements and (ii) require three new disclosures;[5] and

- The issuance by the Public Company Accounting Oversight Boards ("PCAOB") of Staff Audit Practice Alert No. 4 ("Practice Alert") on April 21, 2009 to inform auditors about the potential implications of recent FASB Staff Positions on their reviews of interim financial information and annual audits.[6]

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1 Before FASB codification of U.S. Generally Accepted Accounting Principles ("U.S. GAAP") on July 1, 2009 ("Codification"), the fair value accounting framework in ASC Topic 820 was contained in Statement of Financial Accounting Standards No. 157, *Fair Value Measurements, available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818754924&blobheader=application%2Fpdf. ASC Topic 820 is available at www.fasb.org.

2 This ASU was previously exposed for comments as proposed FSP FAS 157-g, *Estimating the Fair Value of Investments in Investment Companies That Have Calculated Net Asset Value per Share in Accordance with the AICPA Audit and Accounting Guide*, *Investment Companies.* Before Codification, ASUs were referred to as FASB Staff Positions, or "FSPs."

3 *Available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819775311&blobheader=application%2Fpdf .

4 This ASU was previously exposed for comments as proposed FSP FAS 157-f, *Measuring Liabilities under FASB Statement No. 157.*

5 *Available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819724251&blobheader=application%2Fpdf.

6 *See* PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (April 21, 2009), *available at* http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2009/04-21_APA_4.pdf.

I. Background

The FASB promulgated Statement of Financial Accounting Standard No. 157 ("SFAS 157") in September 2006, and it became effective for financial statements issued for fiscal years that began after November 15, 2007.[7] After the FASB codified U.S. Generally Accepted Accounting Principles ("U.S. GAAP") on July 1, 2009, the fair value accounting rubric set forth in SFAS 157 became codified as FASB Accounting Standards Codification ("ASC") Topic 820, *Fair Value Measurements and Disclosures*. ASC Topic 820 provides a framework for measuring and evaluating the fair value of assets and liabilities for purposes of complying with U.S. GAAP.[8] ASC Topic 820 defines fair value as "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." A central concept of ASC Topic 820 is the "fair value hierarchy," which categorizes the inputs used to determine fair value. Level 1 inputs are those with readily verifiable prices, such as stock quotes. Level 2 inputs are those for which there is a market, albeit one with imperfect pricing. Examples of Level 2 inputs include inventory prices and real estate. Level 3 inputs, in contrast, are unobservable and reflect the company's "own assumptions about the assumptions that market participants would use in pricing the asset or liability...developed based on the best information available in the circumstances." Although ASC Topic 820 states that assets and liabilities should be valued using Level 1 and 2 inputs where possible, it permits reporting entities to use Level 3 inputs in situations in which there is little, if any, market activity for the asset or liability at the measurement date. Since its issuance, reporting entities have expressed a desire for application guidance regarding ASC Topic 820. Therefore, the FASB has provided, and continues to provide, clarification and guidance related to fair value accounting principles.[9] Through time, the trend of this guidance has been to enable reporting entities to exercise more judgment in applying the fair value accounting rules, providing these entities with greater flexibility in how they value relevant assets.

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7 *See* FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, *available at* http://www.fasb.org/pdf/fas157.pdf.

8 IAS 39 is the international fair value accounting standard. To date, this Standard and the accompanying guidance set forth by the International Accounting Standards Board ("IASB") have been largely consistent with SFAS 157, ASC Topic 820 and FASB guidance. However, the IASB recently announced its intention to replace IAS 39 with a new standard that will address impairment rules and the possibility of reclassification of certain categories of financial instruments out of the fair value option and into other categories, such as cost-based accounting. This new standard has the potential to diverge significantly from U.S. GAAP. Indeed, European impairment rules differ from those in the United States. For example, EU financial institutions are able to reverse losses in a number of instances where U.S. financial institutions could not. Impairments under the International Financial Reporting Standards ("IFRSs") have different triggers than those in U.S. GAAP. Further, the IASB has signaled disagreement with the FASB's proposal to require the reporting of loans at fair value. Indeed, it has stated that "the IASB is not proposing that the loan book of banks should be held at fair value." For more information, *see* Prepared Statements of Sir David Tweedie, Chairman of the International Accounting Standards Board, to Economic and Monetary Affairs Committee, European Parliament (September 28, 2009), *available at* http://www.iasb.org/News/Announcements+and+Speeches/Statement+of+IASB+Chairman+Sir+David+Tweedie+to+the+Economic+and+Monetary+Affairs+Committe.htm.
See also IASB Chair Charts Path to new Fair Value Standard; Rejects Interim Adoption of US Standard (October 9, 2009), *available at* http://www.financialcrisisupdate.com/2009/10/by-james-hamilton-jd-llm-principal-analyst-cch-federal-securities-law-reporter-and-cch-derivatives-regulation-law-re-1.html.

9 *See, e.g.,* SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, *available at* http://www.sec.gov/news/press/2008/2008-234.htm.

II. ASU No. 2009-12, Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

On September 30, 2009, the FASB issued ASU No. 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. ASU No. 2009-12 amends ASC Subtopic 820-10 to provide guidance for estimating the fair value of investments in certain entities that do not have a quoted market price but calculate net asset value ("NAV") per share (or its equivalent). Such investments are sometimes referred to as "alternative investments," and include investments in hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles and funds of funds. This ASU also provides guidance on the classification of investments within its scope in the fair value hierarchy and provides enhanced disclosure requirements.

This ASU applies to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis and whose investment meets both of the following criteria as of the reporting entity's measurement date:

- The investment does not have a readily determinable fair value; and
- The investment is in an entity that either:
  - has all the attributes of an investment company as specified in ASC 946, *Financial Services--Investment Companies*, 10-15-2;[10] or
  - the investment is in an entity that lacks one or more of the attributes specified in ASC 946-10-15-2, but the investment is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in Topic 946 (*e.g.,* certain investments in real estate funds that measure investment assets at fair value on a recurring basis).

When these criteria are met, ASU No. 2009-12 provides a "practical expedient" to measure the investment's fair value. Specifically, ASU No. 2009-12 permits a reporting entity to estimate the fair value of an alternative investment within its scope using the NAV per share (or its equivalent) of the investment *without further adjustment* if the NAV per share (or its equivalent) of the investment is determined in a manner consistent with Topic 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with Topic 820. If the NAV per share (or its equivalent) of the investment is not as of the reporting entity's measurement date or is not calculated in a manner consistent with the measurement principles of Topic 946, the reporting entity must consider whether an adjustment to the most recent NAV per share (or its equivalent) is necessary. Such an adjustment must take into account significant market events that may have occurred since the investee calculated the NAV per share (or its equivalent). The decision about whether to apply the practical expedient should be made on an investment-by-investment basis and should be applied consistently to an entity's entire position in a particular investment, unless it is probable at the measuring date that a reporting entity will sell a portion of an investment at an amount different from NAV per share (or its equivalent).

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10 *Available at* www.fasb.org.

If the decision is made to use the practical expedient, ASU No. 2009-12 requires a reporting entity to use judgment to determine how to classify the fair value measurement of an investment in the fair value hierarchy. The following considerations should be used in making that determination:

- If a reporting entity has the ability to redeem its investment with the investee at NAV per share (or its equivalent) at the measurement date, the fair value measurement of the investment shall be categorized as a Level 2 fair value measurement.

- If a reporting entity will never have the ability to redeem its investment with the investee at NAV per share (or its equivalent), the fair value measurement of the investment shall be categorized as a Level 3 fair value measurement.

- If a reporting entity cannot redeem its investment with the investee at NAV per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date, the reporting entity should consider the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment should be categorized as a Level 2 or a Level 3 fair value measurement.

A reporting entity is not permitted to use NAV per share (or its equivalent) as a practical expedient in estimating fair value if it is probable that the reporting entity will sell the investment (or a portion thereof) for an amount that is different from NAV per share (or its equivalent). A sale is considered "probable" if all of the following criteria are met as of the reporting entity's measurement date:

- Management, having the authority to approve the action, commits to a plan to sell the investment;

- An active program to locate a buyer and other actions required to complete the plan to sell the investment have been initiated;

- The investment is available for immediate sale subject only to terms that are usual and customary for sales of such investments; and

- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

ASU No. 2009-12 requires enhanced disclosures that will enable users of financial statements to understand the nature and risks of the investments and whether it is probable that the investments will be sold at amounts different from NAV per share (or its equivalent). The disclosure requirements apply regardless of whether the practical expedient is used. Specifically, ASU No. 2009-12 requires that a reporting entity must disclose all of the following information for each interim and annual period separately for each major category of investment:

- The fair value of the investments in the major category, and a description of the significant investment strategies of the investee in the major category;

- For each major category of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity's estimate of the period of time over which the underlying assets are expected to be liquidated by the investees;

- The amount of the reporting entity's unfunded commitments related to investments in the major category;

- A general description of the terms and conditions upon which the investor may redeem investments in the major category;

- The circumstances in which an otherwise redeemable investment in the major category (or portion thereof) might not be redeemable. Also, for those otherwise redeemable investments that are restricted from redemption as of the reporting entity's measurement date, the reporting entity must disclose its estimate of when the restriction from redemption might lapse. If an estimate cannot be made, the reporting entity must disclose that fact and how long the restriction has been in effect;

- Any other significant restriction on the ability to sell investments in the major category at the measurement date;

- If a reporting entity determines that it is probable that it will sell an investment for an amount different from NAV per share (or its equivalent), the reporting entity must disclose the total fair value of such investments and any remaining actions required to complete the sale;

- If a group of investments would otherwise meet the criteria for probable sale at other than NAV per share (or its equivalent), but the individual investments to be sold have not been identified so that the investments continue to qualify for the practical expedient, the reporting entity must disclose its plans to sell and any remaining actions required to complete the sale.

The guidance in ASU 2009-12 is effective for the first reporting period, including interim periods, ending after December 15, 2009. Early application is permitted in financial statements for interim or annual periods that have not yet been issued. If an entity elects to early adopt the guidance regarding the practical expedient and the fair value hierarchy classification, it is not also required to early adopt the related disclosure provisions. Indeed, an entity is not required to adopt the disclosure requirements until the first reporting period that ends after December 15, 2009. In the period of adoption, a reporting entity must disclose any change in valuation technique and related inputs resulting from application of the ASU and must quantify the total effect, if practicable.

III. ASU No. 2009-05, Measuring Liabilities at Fair Value

On August 28, 2009, the FASB issued ASU 2009-05, *Measuring Liabilities at Fair Value*. This ASU amends ASC Subtopic 820-10 to provide guidance on measuring the fair value of liabilities under ASC Topic 820 when a quoted price in an active market for an identical liability is unavailable. Under ASC Topic 820, the term *fair value measurement* includes an assumption that a liability is exchanged in an orderly market transaction. However, due to contractual restrictions, liabilities are rarely transferred in the marketplace. As a consequence, there may be a lack of observable inputs (*e.g.,* quoted prices) for use in determining the fair value of a liability. In circumstances in which a quoted price in an active market for an identical liability is not available, ASU 2009-05 requires that reporting entities measure fair value using one or more of the following techniques:

- 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.

- Another valuation technique that is consistent with the principles of ASC 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.

Regardless of the technique used, however, ASU 2009-05 emphasizes that an entity should maximize the use of relevant observable inputs and minimize the use of unobservable inputs. Furthermore, a reporting entity should apply all applicable guidance in ASU Topic 820 in determining fair value when the volume and level of activity for the asset or liability have significantly decreased and in identifying transactions that are not orderly.

This ASU also addresses situations in which liabilities (*e.g.,* debt obligations) are traded in the marketplace as assets. ASU 2009-05 clarifies that when measuring the fair value of a liability using the price of the liability when traded as an asset, the reporting entity should 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 should be adjusted for factors specific to the asset that are not applicable to the fair value measurement of the liability. ASU 2009-05 lists some circumstances in which a reporting entity should consider whether adjustments are required to the quoted price of the asset. These include:

- The quoted price for the asset relates to a similar (but not identical) liability traded as an asset;

- 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).

ASU 2009-05 clarifies 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 are Level 1 fair value measurements. However, any adjustment to the quoted price of the asset renders the fair value measurement of the liability a lower level measurement in the fair value hierarchy.

In addition, this ASU clarifies the treatment of restrictions on the transfer of a liability. When estimating the fair value of a liability, this ASU would not permit a reporting entity to include a separate input or adjustment to other inputs relating to the existence of a contractual restriction that prevents the transfer of the liability. The ASU explains that such is the case because 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. Therefore, a separate input or adjustment to an existing input into the fair value measurement of a liability is not necessary at a transaction date to reflect the effect of the restriction on transfer. It is also unnecessary at subsequent measurement dates.

The guidance in ASU 2009-05 is effective for the first reporting period, including interim periods, beginning after issuance. Thus, for a calendar-year-end reporting entity, this ASU became effective on October 1, 2009. In the period of adoption, a reporting entity must disclose any change in valuation technique and related inputs and quantify the total effect, if practicable.

IV. Proposed ASU, Improving Disclosures about Fair Value Measurements

On August 28, 2009, the FASB released a proposed ASU called *Improving Disclosures about Fair Value Measurements*. This proposed ASU would amend ASC Subtopic 820-10 and would improve disclosures about fair value measurements by (i) clarifying certain existing required disclosures and (ii) proposing new disclosure requirements. The proposed ASU would affect all entities that are required to make disclosures about recurring and nonrecurring fair value measurements.

If adopted, the proposed ASU would require the following three new disclosures:

- the effect of reasonably possible alternative Level 3 inputs. This disclosure would provide information about the sensitivity of certain fair value measurements. For fair value measurements using significant unobservable Level 3 inputs, if changing one or more of those inputs to reasonably possible alternative inputs would increase or decrease the fair value measurement significantly, the reporting entity would be required to state that fact and disclose the total effect of those changes on the fair value measurement;

- transfers in and/or out of Levels 1 and 2. This disclosure would require a reporting entity to disclose the amounts of significant transfers in and/or out of Level 1 and Level 2 fair value measurements and the reasons for the transfers; and

- activity in Level 3 fair value measurements. In the reconciliation for fair value measurements using significant unobservable Level 3 inputs, this disclosure would require a reporting entity to present information about purchases, sales, issuances and settlements on a gross basis rather than a net basis.

In addition, the proposed ASU would provide the following two clarifications of existing disclosure requirements:

- level of disaggregation. This proposed ASU clarifies that reporting entities should provide fair value disclosures by "class" rather than by "major category." To this end, this proposed ASU amends ASC Topic 820 to replace the term "major category" with the term "class." This change is being made to correct the erroneous belief held by some reporting entities that "major category" means a line item in the statement of financial position. This proposed ASU also provides guidance on the meaning of the term *class* by stating that "[a] class is often a subset of assets or liabilities within a line item in the statement of financial position." A reporting entity would have to apply judgment in determining the appropriate classes of assets and liabilities. In making this determination, reporting entities should consider the nature and risks of the assets and liabilities and their classification in the fair value hierarchy. Reporting entities should also consider the level of disaggregated information already required for specific assets and liabilities under other U.S. GAAP principles.

- disclosures about inputs and valuation techniques. Reporting entities are currently required to provide disclosures about the valuation techniques used to measure fair value. This ASU clarifies that the disclosures about the inputs used are required for both recurring and nonrecurring fair value measurements. This proposed ASU would further clarify that those disclosures are required for fair value measurements that fall in either Level 2 or Level 3.

This proposed ASU is intended to benefit users of financial statements by providing them with information about a *range of fair value* if the reporting entity were to use reasonably possible alternative inputs for Level 3 measurements and significant transfers between Levels 1, 2 and 3. If adopted, this ASU would also provide users with a greater level of disaggregated information and more robust disclosures about valuation techniques and inputs to fair value measurements. If approved, the new disclosures and clarifications would be effective for interim and annual reporting periods ending after December 15, 2009, except for the sensitivity disclosures about Level 3 fair value measurements which would be effective for interim and annual reporting periods ending after March 15, 2010. The FASB was accepting comments on this proposed ASU through October 12, 2009.

V. PCAOB Staff Audit Practice Alert No. 4

On April 21, 2009, the PCAOB released Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments*. The purpose of this Practice Alert is to inform auditors about potential implications of recently issued FSPs[11] on reviews of interim financial information, annual audits, disclosures, and auditor reporting considerations. The Practice Alert informs auditors about the requirements of these FSPs so that they will be better able to evaluate whether reporting entities are acting in compliance with them. The FSPs addressed in the Practice Alert are:

- 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*, which provides guidance for estimating fair value in accordance with SFAS 157 when the volume and level of activity for an asset or liability have significantly decreased. FAS 157-4 also provides guidance on identifying circumstances which may indicate that a transaction is not orderly.[12]

- FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which amends the other-than-temporary impairment ("OTTI") guidance under U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of OTTIs in financial statements.

- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, which requires more frequent and extensive disclosures by publicly traded companies about the fair value of financial instruments.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.

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11 FSPs were renamed ASUs on July 1, 2009 as a result of FASB Codification of U.S. GAAP.

12 For more information on the FSPs discussed in this section, see our firm memorandum, *FASB Issues Three Staff Positions to Improve Guidance and Disclosures Related to Fair Value Measurements and Impairments* (April 20, 2009), *available at* http://www.cahill.com/news/memoranda/000160.