# FASB and IASB Common Fair Value Accounting Guidance

On May 12, 2011, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") issued new, common guidance on fair value measurement and disclosure requirements for U.S. generally accepted accounting principles ("U.S. GAAP") and the International Financial Reporting Standards ("IFRSs").[1] This guidance was issued by

- the FASB in Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* ("ASU No. 2011-04").[2] ASU No. 2011-04 amends Topic 820 of the FASB's Accounting Standards Codification ("ASC Topic 820") of U.S. GAAP, and[3]

- the IASB in new International Financial Reporting Standard 13, *Fair Value Measurement* ("IFRS 13").[4]

## I. Background

The new guidance completes a major project in the FASB and IASB's efforts to converge U.S. GAAP and the IFRSs. Since 2002, the FASB and IASB (collectively, the "Boards") have recognized the need for the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.[5] In 2006, the Boards entered into a Memorandum of Understanding ("MoU"), *A Roadmap for Convergence between IFRSs and US GAAP—2006-2008*.[6] This MoU, as updated in 2008, set forth a list of joint projects on which the Boards sought to achieve accounting standard convergence.[7] One such joint project was fair value measurement. The global financial crisis further emphasized the importance of having common fair value measurement and disclosure requirements in the IFRSs and U.S. GAAP, and the project of converging fair value measurement was therefore given priority status.[8]

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1 *See* IASB and FASB issue common fair value measurement and disclosure requirements (May 12, 2011), *available at* http://www.fasb.org/cs/ContentServer?site=FASB&c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176158544944.

2 *Available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822476398&blobheader=application%2Fpdf.

3 Prior to codification of U.S. GAAP on July 1, 2009 ("Codification"), the fair value accounting framework in ASC Topic 820 was contained in Statement of Financial Accounting Standard No. 157, *Fair Value Measurements* ("SFAS 157").

4 *Available at* www.ifrs.org.

5 *See, e.g.*, The Norwalk Agreement, *available at* http://www.fasb.org/news/memorandum.pdf.

6 *Available at* http://www.iasb.org/NR/rdonlyres/874B63FB-56DB-4B78-B7AF-49BBA18C98D9/0/MoU.pdf.

7 *See* Completing the February 2006 Memorandum of Understanding: A progress report and timetable for completion (September 2008), *available at* http://www.iasb.org/NR/rdonlyres/C1DD5259-4011-4715-A807-1FD71858D37C/0/Memorandum_of_Understanding_progress_report_and_timetable.pdf.

8 *See* Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards, *available at* http://www.iasb.org/NR/rdonlyres/A8B4D5B7-E776-4D80-BA54-17563F1E2297/0/MoU_Status_Update_24June_2010_FINAL.pdf. *See also* our firm memorandum, FASB and

The notion of "fair value" refers to "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."[9] A central concept of fair value accounting 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 a company's own data and assumptions about the assumptions that market participants would use in pricing a given asset or liability. Generally speaking, the fair value accounting rules deal with how inputs at the various levels may be used to value assets and liabilities under different market conditions.

The definition of fair value and the framework for measuring and evaluating the fair value of assets and liabilities for purposes of complying with U.S. GAAP has been codified in ASC Topic 820 since September 2006.[10] By contrast, prior to issuance of IFRS 13, the IFRSs contained no precise definition of fair value, and the requirements for measuring fair value and for disclosing information about fair values were dispersed across many IFRSs, some of which were inconsistent and some of which did not even articulate a clear measurement or disclosure objective.

## II. ASU No. 2011-04 and IFRS 13

ASU No. 2011-04 and IFRS 13 do not extend the use of fair value accounting, but rather provide guidance on how it should be applied where its use is already required or permitted by other standards within U.S. GAAP or the IFRS. ASU No. 2011-04 supersedes much of the guidance in ASC Topic 820, but also clarifies existing guidance and changes certain wording in order to align ASC Topic 820 with IFRS 13. IFRS 13 provides, for the first time, a precise definition of fair value and a single source of fair value measurement requirements, disclosure requirements, and related guidance for use across the IFRSs.

As a result of the new guidance, U.S. GAAP and the IFRSs have the same definition and meaning of fair value and the same substantive disclosure requirements about fair value measurements (with minor differences in wording and style). It is hoped that this will reduce the disparity in application of fair value measurement and disclosure requirements and thereby improve the comparability of financial statements prepared using U.S. GAAP and those using the IFRSs.

ASU No. 2011-04 amends Topic 820 in two ways. Specifically, some of the amendments clarify how to apply the existing fair value measurement and disclosure requirements, while some of the amendments change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements.

The amendments that clarify how to apply the existing fair value measurement and disclosure requirements include the following:

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IASB Issue Progress Report Detailing Modified Convergence Strategy (July 12, 2010), *available at* http://www.cahill.com/news/memoranda/100225/_res/id=sa_File1/FASB%20and%20IASB%20Issue%20Progress%20Report%20Detailing%20Modified%20Convergence%20Strategy.pdf.

9 The definition of "fair value" is now the same in both ASC Topic 820 and IFRS 13.

10 Prior to Codification, the fair value accounting framework was contained in SFAS 157.

- The concepts of highest and best use and valuation premise in a fair value measurement should only be applied when measuring the fair value of nonfinancial assets;

- Consistent with requirements for measuring the fair value of liabilities, the fair value of an instrument classified within a reporting company's shareholders' equity should be measured from the perspective of a market participant that holds the instrument as an asset; and

- A reporting entity should disclose quantitative information about the unobservable inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy.

The amendments in ASU No. 2011-04 that change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements include the following:

- So long as certain criteria are met, a reporting company that holds financial assets and liabilities that expose it to market risks and counterparty credit risk is permitted to measure the fair value of those financial instruments on the basis of the company's net risk exposure;

- Premiums or discounts may be applied in a fair value measurement to the extent that they are consistent with the unit of account and market participants would consider them in a transaction for the asset or liability. However, premiums or discounts related to size as a characteristic of the reporting entity's holding (commonly referred to as blockage factors) rather than as a characteristic of the asset or liability (*e.g.*, a control premium) are not permitted in fair value measurements;

- A reporting entity must make certain additional disclosures about fair value measurements, including:

- With respect to fair value measurements categorized within Level 3 of the fair value hierarchy, the valuation processes used and a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, if any;

- The use of a nonfinancial asset if it differs from the highest and best use assumed in the fair value measurement; and

- The categorization by level of the fair value hierarchy for items that are not measured at fair value in a statement of financial position but for which the fair value is required to be disclosed.

Insofar as the costs and benefits of certain disclosure requirements are different with respect to public and nonpublic companies, the FASB agreed to exempt nonpublic entities from certain disclosure requirements in ASU 2011-04, including:

- Disclosure regarding any transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for such transfers;

- Disclosure about the sensitivity of a fair value measurement categorized within Level 3 of the fair value hierarchy to changes in unobservable inputs and any interrelationships between those unobservable inputs; and

- The categorization by level of the fair value hierarchy for items that are not measured at fair value in the statement of financial position, but for which the fair value of such items must be disclosed.

Although U.S. GAAP and the IFRSs now share the same definition of fair value and the measurement and disclosure requirements are now aligned, some differences remain, including:

- Different disclosure requirements about fair value measurements. For example, the IFRSs require a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorized within Level 3 of the fair value hierarchy, which U.S. GAAP does not require; and

- Different requirements about whether, and in what circumstances, an entity with an investment in an investment company may use the reported net asset value as a measure of fair value.

ASU 2011-04 is effective:

- for public companies, for interim and annual reporting periods beginning after December 15, 2011 and early application is not permitted; and

- for nonpublic entities, for annual periods beginning after December 15, 2011, and early application is permitted but no earlier than for interim periods beginning after December 15, 2011.

IFRS 13 is effective for annual reporting periods beginning on or after January 1, 2013. An entity may apply IFRS 13 to an earlier accounting period as long as it discloses that fact.

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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.