

# Capital Markets Accounting Developments Advisory\*

## Financial Instruments and Credit Group (FICG)

2009-3

December 23, 2009

## FASB to Issue Final Guidance on Additional Fair Value Disclosures

### Overview

On November 11, 2009, the Financial Accounting Standards Board ("FASB" or "the Board") concluded deliberations on its project to amend disclosures for fair value measurements and directed the FASB staff to draft a final Accounting Standards Update ("ASU") for vote by written ballot.

The proposed ASU, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* was issued by the FASB on August 28, 2009 with comments due on October 12, 2009. At the November 11th meeting, the Board discussed the standard's effective date, the proposed new disclosure requirements, and the proposed clarifications of existing disclosure requirements.

The Board's key decisions included:

- Removal of the previously proposed sensitivity analysis for Level 3 measurements from the scope of the ASU

#### Required for financial statements beginning after December 31, 2009

- Retention of the requirement to disclose the amounts of significant transfers in and out of Level 1 and Level 2 measurements and reasons for the transfers
- Clarification of the level of disaggregation of fair value measurements for each *class* of assets and liabilities
- Clarification of the disclosures about inputs and valuation techniques used to determine fair value for Level 2 and Level 3 fair value measurements

#### Required for financial statements beginning after December 31, 2010

- Retention of a provision requiring reporting entities to present the activity within the Level 3 roll forward on a gross (rather than net) basis, including gross presentation of purchases, sales, issuances and settlements

Attachment 1 to this Advisory includes the proposed additional disclosures updated for the recent Board decisions.

This FASB project was added as one of several projects to address recommendations contained in the Securities and Exchange Commission's recent study on mark-to-market accounting, and input provided by the FASB's Valuation Resource Group, and other constituents. The proposed amendment will apply to all entities that measure or disclose fair value on a recurring or nonrecurring basis.

**Additional guidance regarding the proposed ASU may be found at:**

[DataLine 2009-37: FASB Proposes New Fair Value Disclosures](#)

## Summary of Board Decisions

### *Level 3 Sensitivity Disclosures*

The FASB decided not to retain the proposed requirement for Level 3 sensitivity disclosures requirements. The requirements will be reconsidered as part of the joint fair value measurement project with the IASB.

**FICG Observation:** IFRS 7, *Financial Instruments: Disclosures*, currently uses language similar to the deferred Level 3 sensitivity disclosures. Specifically, IFRS 7, paragraph 27(c), requires disclosure of the effect of changes to assumptions if changing "one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly."

IFRS 7 does not currently require disclosure of quantitative information about the significant inputs used and reasonably possible alternative inputs used in the alternative valuation.

A project plan from the IASB and FASB staff will be developed that includes consideration of the sensitivity disclosure requirements. It is possible that future US GAAP disclosure requirements may converge to require a sensitivity analysis as currently required by IFRS 7. In addition, any required sensitivity analysis disclosures under both US GAAP and IFRS may include quantitative information about reasonably possible alternative inputs.

### *Transfers In and Out of Level 1, Level 2, and Level 3*

#### *Transfers into or out of Level 1 and Level 2*

The Board retained the proposed requirement that a reporting entity disclose the amounts of significant transfers into and out of Level 1 and Level 2 fair value measurement classifications and describe the reasons for the transfers, if significant.

#### *Transfers into or out of Level 3*

The proposed ASU included language that would require disclosures and explanations for transfers in and/or out of Level 3. This disclosure requirement was not limited to *significant* transfers. Any transfers in and/or out of Level 3 that are significant would be presented separately (transfers in and transfers out). Any significant transfers shall be presumed to have occurred as of the beginning of the interim period in which the transfer occurred.

**FICG Observation:** The proposed ASU included guidance that specifies that significant transfers between Level 1, Level 2, or Level 3 of the fair value hierarchy shall be presumed to have occurred as of the beginning of the interim period in which the transfer occurred. A key issue is how realized and unrealized gains and losses should be disclosed in the roll forward disclosure. ASC 820 does not currently specify the fair value measurement date at which a Level 3 transfer should be presumed to have occurred.

Consequently, there is diversity in practice among reporting entities. Some entities assumed that the transfers occurred as of the beginning of a period, while others assumed the transfers occurred at the end of a period (or some other point in time). Entities that applied an end of period convention for the Level 3 roll forward to transfers will need to change practices. A change may affect the comparability of prior fair value disclosures.

As a result, we believe it is possible that the final ASU may exclude the requirement to assume all transfers occurred as of the beginning of the period.

The proposed ASU contemplates the disclosure of "significant transfers" between Level 1 and Level 2 of the fair value hierarchy. In addition, for the Level 3 roll forward, the proposed ASU would require transfers into and out of Level 3 to be presented gross to the extent they are deemed to be significant.

Specifically, the proposed ASU states that, "significant shall be judged with respect to earnings and total assets or total liabilities or, when changes in fair values are recognized in other comprehensive income, with respect to total equity." Reporting entities will need to apply judgment to determine what constitutes a "significant" transfer for Level 1, Level 2, and Level 3 fair value measurements.

In addition, the proposed ASU specifies that reporting entities should disclose the reason for transfers between fair value hierarchy levels to the extent they are significant. A qualitative explanation was encouraged previously for the Level 3 roll forward disclosure, and it now will be a formal requirement of ASC 820.

### **Gross Reconciliation of Level 3 Activity**

The Board decided to retain the proposed requirement that a reporting entity present information on a gross basis within the Level 3 roll forward, separately disclosing:

- Purchases,
- Sales,
- Issuances, and
- Settlements of Level 3 items.

**FICG Observation:** For many institutions, the implementation of the Level 3 roll forward disclosure required changes to data systems. The gross roll forward disclosure requirement for purchases, sales, issuances, and settlements (as well as for significant transfers in and out of Levels 1, 2, and 3) may require further changes to systems, specifically with respect to the level of disaggregation of data. Entities should consider the timing and extent of any changes that may be required to implement the required disclosures.

The complexities of this process led the Board to extend the effective date specifically for this disclosure. It is not yet clear whether the effective date of the requirement to separately disclose significant transfers in and out of Level 3 will be extended.

### **Clarifications of Existing Disclosure Requirements**

The Board retained the proposed clarification of the level of disaggregation of fair value disclosures. The ASU will clarify that a reporting entity should apply judgment in determining the appropriate classes of assets and liabilities and provide fair value measurement disclosures for each class of assets and liabilities.

**FICG Observation:** The proposed ASU clarifies that the level of disaggregation required for fair value disclosures should be for each "class" of assets and liabilities. As noted in DataLine 2009-37, "class" has not been defined explicitly, except for debt and equity securities where "class" is the same as "major security type" as defined by ASC 320, *Investments - Debt and Equity Securities*.

Based on feedback from users of financial statements, the FASB expects a greater disaggregation than line items in the balance sheet while allowing for judgment to be applied such that "class" is determined on the basis of nature, risk and classification in the fair value hierarchy. In addition, sufficient information is required to permit a reconciliation of the disclosures to line items in the balance sheet.

The Board retained the proposed clarification of inputs and valuation techniques for Level 2 and Level 3 fair value measurements. The ASU will clarify that a reporting entity should provide disclosures about the input and valuation techniques used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either Level 2 or Level 3.

**FICG Observation:** ASC 820 currently requires the disclosure of the inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs. Diversity in practice exists as to how such disclosures are made and whether they included recurring and nonrecurring Level 2 and Level 3 fair value measurements.

We believe that the FASB has included this clarification to achieve consistency among reporting entities and to provide more detailed information for readers of financial statements. This clarification will result in many reporting entities expanding their qualitative fair value disclosures.

### **Effective Date**

The Board decided that the final ASU will be effective for annual and interim reporting periods beginning after December 15, 2009, except for the requirement to provide the gross reconciliation of Level 3 activity<sup>1</sup>, which will be required for annual and interim reporting periods beginning after December 15, 2010.

Early adoption will be permitted. Initial adoption of the ASU will not require disclosures for earlier periods for comparative purposes.

**FICG Observation:** The change in the effective date was recommended by the vast majority of comment letter respondents. The proposed ASU's effective date would have allowed less than four months of time between the issuance of the final standard and the filing of financial reports reflecting the changes.

Respondents commented that additional time would be necessary to allow for the update of systemic and controlled processes. The FASB staff recommended the change in effective date in consideration of these comments.

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<sup>1</sup> As mentioned above, it is not yet clear whether the effective date of the requirement to separately disclose significant transfers into and out of Level 3 will be delayed as well.

## Attachment 1 - Incremental Disclosure Requirements and Related Effective Dates

Incremental Disclosure Requirement	Effective Date
Amounts of significant transfers into and out of Level 1 and Level 2 fair value measurement classifications and the reasons for the transfers, if significant	Annual and interim reporting periods beginning after December 15, 2009
Fair value measurement disclosures for each class of assets and liabilities. The appropriate classes of assets and liabilities will generally require greater disaggregation than line items in the statement of financial position	
Inputs and valuation techniques used to measure fair value for both recurring and nonrecurring fair value measurements that are classified as either Level 2 or Level 3	
Information on a gross basis within the Level 3 roll forward (rather than one net amount), separately disclosing the following Level 3 items: <ul style="list-style-type: none"> <li>• Purchases,</li> <li>• Sales,</li> <li>• Issuances, and</li> <li>• Settlements</li> </ul>	Annual and interim reporting periods beginning after December 15, 2010