

Heads Up

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FASB Issues Guidance on Measuring Fair Value of Liabilities.

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Introduction

This week, the FASB issued [Accounting Standards Update \(ASU\) 2009-05](#)¹ (previously exposed for comments as proposed FSP FAS 157-f²) to provide guidance on measuring the fair value of liabilities under FASB Accounting Standards Codification Topic (ASC) 820 (formerly Statement 157³). ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance (see [Effective Date](#) section below).

ASU 2009-05 was issued in response to constituents' questions regarding how to measure the fair value of liabilities. ASC 820 requires that the fair value of liabilities be measured under the assumption that the liability is transferred to a market participant (i.e., the liability to the counterparty is not settled, but continues). In practice, however, many liabilities contain restrictions preventing their transfer and few liabilities are transferred to another party, although some liabilities are settled (i.e., extinguished) directly by the issuer with the counterparty and some are traded as assets. Accordingly, constituents requested that the FASB provide additional guidance on how to estimate the fair value of a liability in a hypothetical transaction (assuming the transfer of a liability to a third party), as currently required under ASC 820.

In this *Heads Up*, we discuss how an entity determines the fair value of a liability under ASU 2009-05 and provide a brief update on some related FASB and IASB projects, including the IASB's exposure draft (ED), *Fair Value Measurement*, and discussion paper (DP), *Credit Risk in Liability Measurement*, and the FASB's projects on determining the fair value of certain alternative investments and improving disclosures about fair value measurements.

Determining Fair Value of Liabilities

Application Guidance

ASU 2009-05 reaffirms that fair value measurement of a liability assumes the **transfer** of a liability to a market participant as of the measurement date; that is, the liability is presumed to continue and is not settled with the counterparty. In addition, ASU 2009-05 reemphasizes that a fair value measurement of a liability includes nonperformance risk⁴ and that such risk does not change after transfer of the liability. In a manner consistent with this underlying premise (i.e., a transfer notion), the ASU requires that an entity should first determine whether a quoted price of an identical liability traded in an active market exists (i.e., a Level 1 fair value measurement). The ASU clarifies that the quoted price for the identical liability, **when traded as an asset** in an active market, is also a Level 1 measurement for that liability when no adjustment to the quoted price is

¹ FASB Accounting Standards Update 2009-05, "Measuring Liabilities at Fair Value."

² Proposed FASB Staff Position No. FAS 157-f, "Measuring Liabilities Under FASB Statement No. 157."

³ FASB Statement No. 157, *Fair Value Measurements*.

⁴ The glossary of ASC 820 describes nonperformance risk as "the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Nonperformance risk includes but may not be limited to the reporting entity's own credit risk."

The ASU emphasizes that regardless of the technique(s) used, an entity should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

required. In the absence of a Level 1 measurement, an entity must use one or more of the following valuation techniques to estimate fair value (in a manner consistent with the principles in ASC 820), which can be classified into two broad categories:

- A valuation technique that uses a quoted price:
 - Quoted price of an identical liability when traded as an asset.
 - Quoted price of a similar liability or of a similar liability when traded as an asset.
- Another valuation technique (e.g., a market approach or an income approach), including one of the following:
 - A technique based on the amount an entity would pay to transfer the identical liability.
 - A technique based on the amount an entity would receive to enter into an identical liability.

Editor’s Note: Although a market approach or an income approach may reflect an “entry” price (i.e., the proceeds an entity would receive if it were to issue an identical liability as of the measurement date), the ASU emphasizes that the inputs to the technique should reflect market participants’ assumptions. In the estimation of fair value under this approach, an entity’s principal (or most advantageous) market would be the issuance market for its liability.

The ASU emphasizes that regardless of the technique(s) used, an entity should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

A significant difference between the fair value measurement of an asset and that of a liability relates to the treatment of restrictions. While ASC 820-10-35-19 (formerly paragraph 6 of Statement 157) requires that restrictions on the sale of the asset that are an attribute of the asset be considered in the fair value measurement of an asset, the ASU states that a separate adjustment for the impact of a restriction on the transfer of a liability should not be made in the fair value measurement of a liability. So what does this mean?

Simply put, a fundamental difference between a restriction on an asset and a restriction on a liability is that the restriction on the transfer of a liability relates to its performance (i.e., liabilities typically have legal or contractual transfer restrictions such that the obligor cannot be changed to someone less likely to perform in making the principal and interest payments or other obligations), whereas a restriction on an asset relates to its sale (i.e., the holder’s ability to sell the asset) rather than its performance. The ASU clarifies that the effect of a restriction on the transfer of a liability is already factored into the transaction price of the liability at inception, since both the issuer and the creditor have accepted the terms of the transaction (i.e., debt issuance). Because of these key attributes, an entity should not make a separate adjustment for restrictions on the transfer of a liability in estimating the liability’s fair value.

Although an entity is not required to make a separate adjustment for a restriction on the transfer of a liability when measuring the liability’s fair value, in certain circumstances, an entity may be required to consider the impact of factors that affect the quoted price of the liability when traded as an asset. Some instances identified in the ASU include:

- The quoted price of an asset relates to a similar (not identical) liability whose fair value is being measured by reference to the asset.
- The quoted price of an asset includes the effect of a third-party guarantee. Under ASC 820-10-35-18A (formerly Issue 08-5⁵), a credit enhancement attached to a liability should not be considered in its fair value measurement. Therefore, if the quoted price of the liability when traded as an asset includes the effect of a credit enhancement (i.e., a guarantee), this effect should be excluded from the measurement of the liability.

⁵ EITF Issue No. 08-5, “Issuer’s Accounting for Liabilities Measured at Fair Value With a Third-Party Credit Enhancement.”

The following example illustrates the guidance in the ASU:

Facts: On January 1, 20X1, Company A issues a \$1 million, five-year fixed-rate bond with an annual 5 percent coupon at a discount. Company A receives \$948,000 upon issuance. Company A elects the fair value option and accounts for the bond at fair value.

Scenario 1: Assume the bond trades in an active market. Since the bond is traded in an active market, the company uses the quoted price of the bond traded as an asset in an active market to determine the fair value of its liability. In determining whether the quoted price of the asset is determinative of the fair value of the liability, the issuer should consider whether the quoted price of the asset includes any features (e.g., a third-party guarantee) that would not be considered in the fair value of the liability.

Scenario 2: Now assume that the bond is issued in a private placement to a select group of investors who cannot sell the bond to another party for the term of the bond. The fair value under this scenario upon issuance is the same price as in scenario 1 (i.e., \$948,000). Note that no adjustment is required to the transaction price at initial recognition, since both parties (i.e., the issuer and the investor) have agreed to the transaction price. In determining fair value after initial recognition, A determines that no recent transactions have occurred for identical or similar liabilities in the marketplace and therefore uses the income approach to estimate fair value. Under ASU 2009-05, A may use an approach that reflects the proceeds it would receive if it were to issue an identical liability as of the measurement date with the same remaining term and the same remaining cash flows.

Effective Date

The guidance in ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance. Therefore, for a calendar-year-end entity, the ASU becomes effective on October 1, 2009. Entities may also elect to early adopt the ASU if financial statements have not been issued. In the period of adoption, an entity is required to disclose any change in valuation technique and related inputs and quantify the total effect, if practicable.

Related Projects — A FASB and IASB Project Update

IASB's Exposure Draft on Fair Value Measurements

In May 2008, the IASB issued for public comment an ED on fair value measurements. The purpose of the ED is to establish a consistent framework for measuring fair value under International Financial Reporting Standards (IFRSs). Comments on the ED are due by September 28, 2009. The ED includes guidance on measuring the fair value of liabilities that is broadly similar to that proposed by the FASB in FSP FAS 157-f. While the ED is consistent with U.S. GAAP in most respects, there are a few differences. For more information, see Deloitte's [June 30, 2009, Heads Up](#).

IASB Discussion Paper on Credit Risk in Liability Measurement

In June 2009, the IASB issued for public comment a DP on the role of credit risk in liability measurement. The DP notes that while fair value includes the effects of the issuer's nonperformance risk, it does not follow that other current measurements of a liability should reflect the issuer's credit risk. Comments on the DP are due by September 1, 2009. The IASB hopes that the comments received on the DP will help guide it in any future decisions about use of a current measurement to measure liabilities (including measurement of financial liabilities, asset retirement obligations, product warranty liabilities, insurance claim liabilities, and employee benefit obligations). The three principal alternatives to fair value identified in the DP are:

- *The "borrowing penalty" approach* — In this approach, liabilities are measured at the present value of the expected future cash flows (excluding expectations about defaults) and are discounted by using the risk-free rate of interest. Any difference between this present value and the proceeds received is charged to earnings immediately upon initial recognition. Subsequent measurements incorporate changes in risk-free interest rates. Thus, interest expense is computed at the current risk-free rate.

The guidance in ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance.

- *The “shareholder put” approach* — Similarly to the “borrowing penalty” approach, this approach is used to measure liabilities at the present value of the expected future cash flows (excluding expectations about defaults) discounted by using the risk-free rate of interest. However, any difference between this present value and the proceeds received is charged to equity and amortized to earnings over the life of the liability. Subsequent measurements incorporate changes in risk-free interest rates. Interest expense is computed at the current risk-free rate adjusted by the amortization of the amount that was reported in equity.
- *The “frozen spread” approach* — This approach is used to measure liabilities that result from a cash exchange initially at the amount of cash proceeds. Subsequent measurements incorporate changes in risk-free interest rates, but not changes in the issuer’s credit spread. Interest expense is computed at the current risk-free rate adjusted by the frozen initial credit spread.

For a summary of the DP, see Deloitte’s June 2009 *IAS Plus* newsletter.

FASB Proposal on Determining Fair Value of Certain Interests in Alternative Investments

On June 8, 2009, the FASB issued for public comment proposed FSP FAS 157-g,⁶ which provides a practical expedient for measuring the fair value of certain alternative investments that calculate and report net asset value. The comment period on the proposed FSP (which will be issued in the form of an ASU) ended on July 8, 2009. We expect the FASB to issue a final ASU in the near future. The final ASU will be effective for interim and annual periods ending after December 15, 2009, with early adoption permitted. Entities may elect to early adopt the measurement principles of the final ASU but would not be required to early adopt the final ASU’s disclosure provisions. Stay tuned for updates.

FASB Initiates Project on Improving Disclosures About Fair Value Measurements

Earlier this year, the FASB initiated a project aimed at improving disclosures about fair value measurements. In addition to clarifying certain existing disclosure requirements, the project will include consideration of three new disclosures about (1) sensitivity of fair value measurements to changes in unobservable assumptions (applicable to Level 3 measurements only), (2) transfers between Levels 1 and 2 of the fair value hierarchy, and (3) gross presentation of information about purchases, issuances, and settlements included in the rollforward reconciliation of Level 3 fair value measurements. The FASB expects to issue an ED of its proposed ASU for a 45-day comment period shortly. If finalized, the proposed ASU would be effective for interim and annual periods ending after December 15, 2009, except for Level 3 sensitivity disclosures, which would be effective for interim and annual periods ending after March 15, 2010.

Earlier this year, the FASB initiated a project aimed at improving disclosures about fair value measurements.

⁶ Proposed FASB Staff Position No. 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*.”

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