

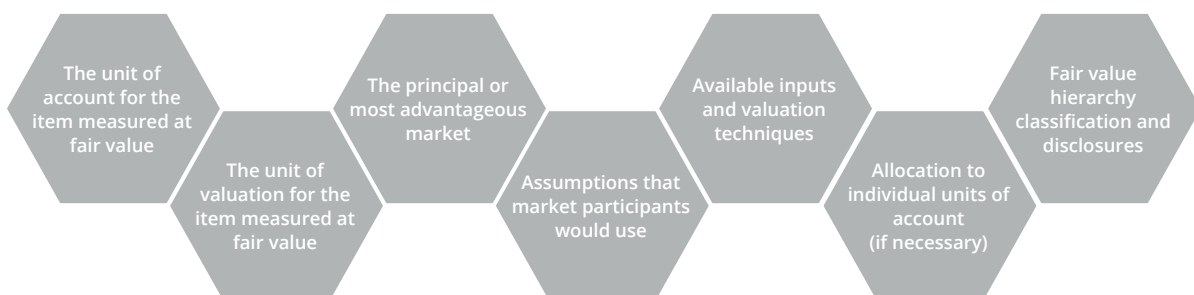


On the Radar

Fair Value Measurements and Disclosures (Including the Fair Value Option)

Most entities have amounts that are recognized at fair value in their financial statements. ASC 820 defines fair value, sets out a framework for measuring it, and establishes fair value disclosure requirements. However, ASC 820 does not specify when an entity is required or permitted to measure assets, liabilities, equity instruments, or transactions at fair value; this requirement is addressed in other U.S. GAAP.

An entity must consider the following issues in applying the fair value measurement framework in ASC 820:



Common Misconception

A fair value measurement is a market-based measurement based on an exit price notion and is not entity-specific. Therefore, a fair value measurement must be determined on the basis of the assumptions that market participants would use in pricing an item, regardless of whether those assumptions are observable or unobservable. A measurement based on "true value," "economic value," or management's perception of value is not consistent with a fair value measurement. The fair value hierarchy in ASC 820 serves as a basis for considering market-participant assumptions and distinguishes between (1) market-participant assumptions developed on the basis of market data that are independent of the entity (observable inputs) and (2) an entity's own assumptions about market-participant assumptions developed on the basis of the best information available in the particular circumstances, including assumptions about the risks inherent in inputs or valuation techniques.

Fair Value Measurement Framework

The fair value measurement guidance was originally issued in September 2006. Although it has been subsequently amended since its original issuance, the general framework has not changed and significant future changes are not expected. An entity needs to perform various steps to (1) prepare a fair value measurement that complies with the measurement principles in ASC 820 and (2) meet the disclosure requirements in ASC 820. An entity may apply the following step-by-step approach to measure and disclose fair value when the initial or subsequent measurement of an asset, liability, or equity instrument at fair value is required or permitted by other U.S. GAAP:

Fair Value Measurement Application Framework



- *Step 1: Identify the unit of account* — The unit of account represents the level of aggregation or disaggregation of individual assets, liabilities, or equity instruments for recognition in the financial statements and, with the exception of items for which there are quoted prices in an active market, is determined on the basis of other U.S. GAAP.
- *Step 2: Identify the unit of valuation* — The unit of valuation is often consistent with the unit of account, but there are exceptions. The unit of valuation for nonfinancial assets (other than nonfinancial derivative assets) is the asset's highest and best use. In addition, the unit of valuation for certain groups of financial assets, financial liabilities, and nonfinancial items accounted for as derivatives may represent a portfolio of items with offsetting risk positions.
- *Step 3: Identify the principal or most advantageous market* — Under ASC 820, it is assumed that an entity will transact in its principal market or, in the absence of a principal market, the most advantageous market. This determination is important because exit prices are not the same in different markets. In most situations, there will be a principal market, which represents the market with the greatest volume and level of activity for the item. The market in which the entity normally transacts is generally the principal (or most advantageous) market.
- *Step 4: Develop assumptions that market participants would use to measure fair value* — To meet the "exit price" measurement objective, an entity must develop assumptions that market participants would use to determine the price of an asset, liability, or equity instrument in an orderly transaction as of the measurement date, even if those assumptions are based on unobservable information. An entity may not substitute the assumptions of market participants with its own assumptions that differ from those of market participants.
- *Step 5: Measure fair value on the basis of available inputs and appropriate valuation techniques* — The initial fair value measurement of an item will often be equal to its transaction price. However, in certain situations, the transaction price does not equal an exit price on initial recognition. In subsequently measuring items at fair value, an entity must maximize the use of observable inputs and minimize the use of unobservable inputs. Entities must use valuation techniques that are consistent with the techniques that market participants would use to determine an exit price. Since a quoted market price for an identical item in an active market (i.e., a Level 1 input) constitutes the most reliable evidence of fair value, this price must be used to measure fair value when available. Although a significant decrease in the volume and level of activity in relation to normal market activity may affect the entity's selection of techniques or inputs, it does not change the fair value measurement objective. Entities cannot incorporate measurements that are inconsistent with fair value on the basis that (1) an entire market is functioning in a disorderly manner or (2) an entity would not enter into a transaction to sell an asset or transfer a liability at the current market price.
- *Step 6: Allocate fair value measurement to individual units of account (if necessary)* — An entity may be required to allocate a fair value measurement when the unit of account for the item measured at fair value differs from the unit of valuation. In some cases, an allocation will be required even when the unit of account and unit of valuation are the same. Such allocations are performed in accordance with other U.S. GAAP.
- *Step 7: Classify the fair value measurement within the fair value hierarchy and prepare disclosures* — Under ASC 820, inputs used in fair value measurements are categorized into a three-level fair value hierarchy. In addition to requiring the disclosure of items measured at fair value within this hierarchy (i.e., Level 1, Level 2, or Level 3), ASC 820 requires entities to provide numerous quantitative and qualitative disclosures about fair value measurements.

As is evident in its comment letters on registrants' filings, the SEC staff closely scrutinizes the fair value disclosures provided by entities, focusing on missing or confusing disclosures. The staff often will request entities to modify or supplement disclosures.

Items Required or Eligible to Be Measured at Fair Value

With certain exceptions, the measurement guidance in ASC 820 applies whenever another Codification topic uses the phrase “fair value” to describe how an entity is required or permitted to measure financial and nonfinancial assets and liabilities, instruments classified in a reporting entity’s stockholders’ equity, or specific transactions, regardless of whether this measurement pertains to initial or subsequent recognition or to disclosure. Therefore, before applying the fair value measurement framework in ASC 820, entities must determine whether fair value measurement under ASC 820 is required or permitted by other U.S. GAAP.

In addition, certain Codification topics permit, but do not require, an entity to measure an asset or liability at fair value. Most notably, ASC 825 permits entities to elect the fair value option to account for certain financial assets and financial liabilities at fair value. Entities may also elect to account for certain assets or liabilities, including nonfinancial items, at fair value according to other Codification topics (e.g., ASC 860-50 permits entities to recognize servicing assets and servicing liabilities at fair value). Any measurement of an item at fair value must be performed in accordance with ASC 820 unless the use of another measurement approach is specifically required by U.S. GAAP.

Deloitte’s Roadmap *Fair Value Measurements and Disclosures (Including the Fair Value Option)* comprehensively discusses the scope, measurement, and disclosure guidance in ASC 820 and other U.S. GAAP.

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