

AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

BDO KNOWS: FINANCIAL SERVICES



► SUBJECT

NEW GUIDANCE ON FAIR VALUE

► DETAILS

In May 2011, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued new, converged guidance on fair value. The guidance was issued by:

- The FASB in Accounting Standards Update No. 2011-04, Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04); and
- The IASB in new International Financial Reporting Standard (IFRS) No. 13, "Fair Value Measurement."

The new guidance aligns the fair value measurement and disclosure requirements under U.S. GAAP and IFRS. The amendments do not change the requirements for when fair value accounting should be used; rather, they provide guidance on how it should be applied where its use is already required or permitted by other standards within IFRS or U.S. GAAP.

While the new guidance is not expected to significantly impact current practice, some of the amendments could result in changes to a reporting entity's fair value measurements. Some of the more significant revisions and clarifications contained in ASU 2011-04 are discussed below.

Principal (or Most Advantageous) Market

Topic 820 states that a fair value measurement is assumed to take place in the principal market *for the asset or liability* or, in the absence of a principal market, the most advantageous market for the asset or liability. The ASU clarifies that the principal market should be determined based on the market with the greatest volume or level of activity for the asset or liability, i.e. not on the basis of the entity's transactions in a particular market. It also specifies that a reporting entity can use the price in the market in which it normally enters into transactions, unless there is evidence that the principal market and that market are not the same. Consequently, a reporting entity does not need to perform an exhaustive search for markets that might have more activity for the asset or liability than the market in which that entity normally enters into transactions.

Valuation Premise and Highest and Best Use

Current U.S. GAAP incorporates the concept of *in-use* and *in-exchange* when measuring fair value. "In-use" provides maximum value to market participants via its use with other assets, whereas "in-exchange" provides maximum value on a stand-alone basis.

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The new guidance eliminates in-use and in-exchange concept and instead prescribes the objectives of the valuation premise – i.e. highest and best use may provide maximum value either in combination with a group of assets (formerly in-use) or on a standalone basis (formerly in-exchange).

The new guidance also eliminates the concepts of the valuation premise and highest and best use and when measuring the fair value of financial instruments. This is a significant change from current guidance. It means that the grouping of financial instruments for purposes of determining their fair value will be prohibited (except as provided for under the exception for portfolios, discussed below). Instead, financial instruments must be measured on a stand-alone basis.

Measuring Portfolios of Financial Instruments

While the grouping of financial assets and liabilities is prohibited under the new guidance, an exception was provided for financial assets and liabilities that are held and managed on a portfolio basis and that have offsetting market risks or counterparty credit risks when certain criteria are met. The exception permits fair value measurement for such groups of financial assets and liabilities using a price that would be received or paid to sell or transfer the net portfolio position.

In order to qualify for the exception, a reporting entity must meet following criteria:

- It must manage the group of financial assets and liabilities on the basis of its net exposure to a particular market risk (or risks) or to the credit risk of a counterparty based on the entity's documented risk management or investment strategy. Market risks include interest rate risks, currency risk, or other price risk;
- It provides information that basis about the group of financial assets and liabilities to management;
- It is required to or has elected to measure financial assets and liabilities at fair value in the balance sheet at each reporting date;
- It has made an accounting policy decision to use the exception and apply it consistently from period to period for the portfolio.

A reporting entity that uses the portfolio measurement exception can apply the bid-ask spread guidance to a portfolio's net position in a particular market risk only if the market risks that are being offset are substantially the same. The ASU includes guidance to help determine whether market risks are substantially the same. In applying the bid-ask adjustments to the individual assets and liabilities that make up a portfolio, an entity should use a quantitative allocation method that is reasonable and consistently applied and is appropriate in the circumstances.

In applying the portfolio measurement guidance, when a legally enforceable right exists to offset financial assets and liabilities if a counterparty defaults (e.g. a master netting arrangement), an entity is permitted to apply an adjustment to the net exposure of the counterparty's credit risk for the instruments being valued.

Blockage Factors and Other Premiums and Discounts

Under current US GAAP, applying a blockage factor (a discount to reflect the impact of selling a large block of a security at one time) is prohibited for Level 1 fair value measurements (i.e. instruments with quoted prices for an identical instrument in an active market).

The ASU clarifies that premiums or discounts related to the size as a characteristic of the reporting entity's holding (specifically, a blockage factor) rather than as a characteristic of the asset or liability (such as a control premium) are not permitted in a fair value measurement.

The guidance does permit attributes specific to an asset or liability, such as restrictions on the sale or use of the asset or a control premium when measuring the fair value of a controlling interest, to be considered for fair value measurements that aren't a level 1 measurement, when market participants would do so when pricing the asset or liability given the unit of account specified in other guidance. Therefore, the incorporation of a control premium into the per-share fair value of the acquirer's interest in an acquiree would continue to be appropriate in the case of a fair value measurement in connection with a business combination or goodwill impairment testing.

Instruments Classified in Shareholders' Equity

For instruments classified in shareholders equity (for example, stock issued as consideration in a merger or acquisition) the guidance clarifies that such instruments should be measured from the perspective of a market participant that holds the instrument as an asset. This clarification isn't expected to affect most companies' current practices.

Disclosures

The ASU requires several new disclosures:

- **Transfers between Level 1 and Level 2** – Previous guidance required disclosure of *significant* transfers between level 1 and level 2 of the fair value hierarchy. Under the guidance in the new ASU, disclosure of *all* transfers between those levels is required (non-public companies are exempt from this requirement).
- **Level 3 Fair Value measurements** – the following additional disclosures are required:
 - Quantitative information about significant unobservable inputs used for all Level 3 measurements. A reporting entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the reporting

entity when measuring fair value (for example, when a reporting entity uses prices from prior transactions or third-party pricing information without adjustment). However, when providing this disclosure, a reporting entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the reporting entity.

- A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measure and the interrelationship between inputs (not required for non-public entities).
- A description of the valuation processes used by the reporting entity (including, for example, how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period).
- Highest and best use – For non-financial assets, if the highest and best use of a nonfinancial asset differs from its current use, a reporting entity must disclose that fact and why the nonfinancial asset is being used in a manner that differs from its highest and best use.
- Financial instruments not measured at fair value – For each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed, a reporting entity must disclose the fair value hierarchy that the measurement falls within. (for example, long term debt that is recorded at amortized cost on the balance sheet but for which fair value disclosure is required). This disclosure is not required for non-public entities.

Effective Date and Transition

For public entities, the ASU is effective for interim and annual periods beginning on or after December 15, 2011. Early adoption is prohibited. Non-public entities are required to adopt the ASU in annual periods beginning after December 15, 2011. Non-public entities are permitted to early adopt the ASU for any interim period beginning after December 15, 2011.

The amendments in this Update are to be applied prospectively. This means that any changes to fair value measurements that result from applying the ASU should be recognized in income in the period of adoption as a change in estimate. In the period of adoption, companies should also disclose changes in valuation techniques and related inputs resulting from the application of the new guidance and should quantify the total effect, if practicable.

Differences Between U.S. GAAP and IFRS

The following key differences remain between U.S. GAAP and IFRS:

- **Day one gains and losses** – Under ASC 820, the immediate recognition of gains and losses for the difference between the transaction price and fair value (i.e. day one gains and losses) is permitted even when the fair value measurement is based on inputs that are unobservable. The ASU confirms this guidance and adds the following clarifying language in ASC 820-10-30-6:
If another Topic requires or permits a reporting entity to measure an asset or a liability initially at fair value and the transaction price differs from fair value, the reporting entity shall recognize the resulting gain or loss in earnings unless that topic specifies otherwise.
While IFRS 13 contains similar language, certain standards, including IFRS 39, *Financial Instruments: Recognition and Measurement* and IFRS 9, *Financial Instruments*, restrict day one gains and losses when fair value is based on unobservable inputs (i.e., Level 2 or Level 3 inputs).
- **Measuring the fair value of certain investments** – Topic 820 provides a practical expedient that permits a reporting entity with an investment in an entity reporting under ASC 946 (i.e. investment companies) to use as a fair value measure the investment company's reported net asset value, without adjustment, under certain conditions. The FASB retained this guidance in the ASU. However, under IFRS there currently is no practical expedient for measuring the fair value of investment companies.
- **Disclosure requirements** – IFRS 7, *Financial Instruments: Disclosures*, currently requires a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorized within Level 3 of the fair value hierarchy. This requirement was carried forward into IFRS 13. U.S. GAAP does not contain such a requirement.

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