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Heads Up

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A Framework for Effectiveness

FASB Proposes Amendments to the Disclosure Requirements for Fair Value Measurements

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Introduction

On December 3, 2015, the FASB issued for public comment a proposed ASU[1] that would amend the requirements in ASC 820[2] for disclosing fair value measurements. The proposal is part of the FASB's disclosure framework project, which the Board launched in March 2014 to improve the effectiveness of disclosures in notes to financial statements. Among other changes, the proposed ASU would introduce a potentially significant new requirement for public business entities to provide information about unrealized gains and losses arising during the reporting period separately for Level 1, Level 2, and Level 3 fair value measurements (currently, this information is only required for Level 3 fair value measurements). Comments on the proposal are due by February 29, 2016.

This *Heads Up* summarizes the proposed ASU's key provisions, which can vary depending on whether an entity is a private company.[3] Appendix A lists the proposal's questions for respondents, and Appendix B reproduces certain of the proposal's illustrative examples.

Key Provisions of the Proposed ASU

Objective for Fair Value Measurement Disclosures

The proposed ASU would add the following objective to ASC 820 to encourage preparers to use discretion in complying with the disclosure requirements:

> The objective of the disclosure requirements . . . is to provide users of financial statements with information about all of the following:
>
> a. The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
>
> b. The effects of changes in fair value on the amounts reported in financial statements
>
> c. The uncertainty in the fair value measurement of Level 3 assets and liabilities as of the reporting date
>
> d. How fair value measurements change from period to period.

[1] FASB Proposed Accounting Standards Update, *Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement*.

[2] FASB Accounting Standards Codification Topic 820, *Fair Value Measurement.*

[3] The ASC Master Glossary defines a private company as "[a]n entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting."

Proposed additions, eliminations, and modifications to the fair value disclosure requirements in ASC 820 are discussed below.

Unrealized Gains and Losses for All Levels — A New Disclosure Requirement for Public Business Entities

Under the proposed ASU, entities that are not private companies would disclose fair value changes for assets and liabilities held as of the balance sheet date, disaggregated by fair value hierarchy level (i.e., Levels 1, 2, and 3) for (1) net income before taxes and (2) comprehensive income. Such disclosures are currently only required for the Level 3 amounts within net income under ASC 820-10-50-2(c) and (d). In a manner consistent with the private-company decision-making framework, the new requirement would not apply to a private company.

Editor's Note: The requirement to provide disclosures about unrealized gains and losses from recurring Level 3 fair value measurements that arise during a reporting period was described in the Basis for Conclusions of Statement 157[4] (the predecessor to ASC 820). Statement 157 indicated that this disclosure could provide information to financial statement users about the "quality of earnings" given the subjectivity inherent in Level 3 fair value measurements.

In the proposed ASU, the Board indicated that financial statement users want disclosures about all unrealized gains and losses from fair value measurements that occur during a reporting period because this information can provide insight into the volatility of fair value measurements.

Eliminated and Modified Disclosure Requirements

Policies Related to the Timing of Transfers Between Levels and to Transfers Between Levels 1 and 2

Currently, ASC 820 requires an entity to disclose its policy on the timing of transfers between levels of the fair value hierarchy. The entity would still be required to have a consistent policy on the timing of such transfers; however, the proposal would remove the entity's requirement to disclose its policy as well as to separately disclose the amounts transferred between Level 1 and Level 2 and the corresponding reason for doing so.

Level 3 Fair Value Measurements

The disclosure requirements for Level 3 fair value measurements would be amended as follows:

- *Valuation Process* — The proposed ASU would remove the requirement under ASC 820-10-50-2(f) (and related implementation guidance under ASC 820-10-55-105) for an entity to disclose its valuation processes for Level 3 fair value measurements.

[4] FASB Statement No. 157, *Fair Value Measurements* (superseded).

Editor's Note: Removal of the disclosure requirement in ASC 820-10-50-2(f) would result in divergence between U.S. GAAP and IFRSs. The requirement was added to the FASB's and IASB's jointly issued fair value measurement standard on the basis of a recommendation by the IASB's expert panel. The panel explained that the disclosure would help users understand the quality of an entity's fair value estimates and give investors more confidence in management's estimate. The proposed ASU removes the requirement because it would conflict with the Board's proposed concepts statement chapter.[5] The Board indicated that disclosure of internal control procedures is outside the purpose of the notes to the financial statements and is not required under other topics in U.S. GAAP.

Removal of this requirement would not change management's responsibility for internal controls over the valuation process and related auditor testing. Further, it should not affect investor confidence in the quality of the fair value estimate given the regulatory environment in the United States (e.g., SEC and PCAOB) as well as the intense scrutiny in this area. The Board also noted that investors are typically familiar with the overall valuation process.

- *Measurement uncertainty* — The proposal would retain the requirement in ASC 820-10-50-2(g) that entities provide a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. However, it would clarify that the intent of this requirement is for entities to communicate information about uncertainty in measurement as of the reporting date and not for them to disclose information about sensitivity to future changes in fair value.
- *Quantitative information about unobservable inputs* — The proposed ASU would clarify that disclosures about the range **and** weighted average of unobservable inputs must comply with ASC 820-10-50-2(bbb) (as indicated in the proposed implementation guidance in ASC 820-10-55-103). **Under the proposed ASU, the time period used to develop significant unobservable inputs would be an additional required disclosure** (see Appendix B for an example of this disclosure). A private company would not be required to provide disclosures about the range, weighted average, or time period used to develop significant unobservable inputs.
- *Level 3 rollforward* — The proposed ASU would retain the Level 3 rollforward requirement for entities that are not private companies. For entities that are **private companies**, the proposed ASU would modify the Level 3 rollforward requirement and remove the requirement to disclose the change in unrealized appreciation or deprecation related to investments held as of the balance sheet date under ASC 820-10-50-2(d). Disclosures would only be required about transfers into and out of Level 3 and purchases (or issues) of Level 3 investments.

Editor's Note: In its outreach on the Level 3 rollforward, the FASB determined that the full Level 3 rollforward was generally deemed less useful for users of private-company financial statements and that transfers into and out of Level 3 were generally considered to be the most useful aspect of the rollforward. Accordingly, the proposed ASU would only require entities to disclose transfers into (and out of), as well as purchases (or issues) of, Level 3 investments, and this could be achieved in a sentence rather than in a tabular rollforward.

A defined benefit plan sponsor that is a private company would not have to disclose the reconciliation of beginning and ending balances for plan investments categorized as Level 3 within the fair value hierarchy (i.e., the Level 3 rollforward); instead, it would only be required to disclose transfers into and out of Level 3 and purchases (or issues) of Level 3 assets in its defined benefit plan footnote (see the FASB's project update page for more details on its review of defined benefit plan disclosures).

[5] FASB Proposed Concepts Statement, *Conceptual Framework for Financial Reporting — Chapter 8: Notes to Financial Statements.*

Net Asset Value Disclosures of Estimates of Timing of Future Liquidity Events

Under the proposed ASU, the disclosures about the timing of liquidity events[6] for investments measured at fair value would apply only when they have been communicated to the reporting entity by the investee or announced publicly. If the timing is unknown, the entity would be required to disclose that fact.

Editor's Note: The objective of this change is to prevent an investor from having to make its own estimate when it does not have knowledge of the timing from the investee or other public source.

Effective Date and Transition

The FASB did not propose an effective date. Rather, the Board indicated that it plans to determine such date after considering stakeholders' feedback on the proposed ASU. Entities would apply the new guidance prospectively, beginning in the period of adoption, to disclosures about changes in unrealized gains and losses and changes related to quantitative information about unobservable inputs. All other amendments would be applied retrospectively to all periods presented.

[6] See ASC 820-10-50-6A(b) and 50-6A(e).

Appendix A — Questions for Respondents

The proposed ASU's questions for respondents are reproduced below for ease of reference.

Question 1: Would the proposed amendments result in more effective, decision-useful information about fair value measurements? If not, please explain why. Would the proposed amendments result in the elimination of decision-useful information about fair value measurements? If yes, please explain why.

Question 2: Are the proposed disclosure requirements operable and auditable? If not, which aspects pose operability or auditability issues and why?

Question 3: Would any of the proposed disclosures impose significant incremental costs? If so, please describe the nature and extent of the additional costs.

Question 4A: The proposed amendments would apply to all entities, except for certain requirements in paragraph 820-10-50-2(bbb) through (d), for which private companies would be exempt. Do you agree with the exemption for private companies? If not, please describe why and which disclosures should be required for private companies.

Question 4B: Should entities other than public business entities (for example, employee benefit plans and not-for-profit organizations) also be exempt from the proposed amendments mentioned in Question 4A? If yes, please describe why and which disclosures they should be exempt from.

Question 5: The proposed amendments to paragraph 820-10-50-2(bbb) require that a reporting entity disclose the weighted average of significant unobservable inputs used in Level 3 fair value measurements. Are there classes of financial instruments for which this disclosure is inoperable or does not provide meaningful information? If yes, please describe those classes of financial instruments and explain why.

Question 6: The proposed amendments to paragraph 820-10-50-2(bbb) require that a reporting entity disclose the time period used to develop significant unobservable inputs. What would be the costs associated with including this disclosure? Would this disclosure provide more effective, decision-useful information?

Question 7: Are there any other disclosures that should be required by Topic 820 on the basis of the proposed Concepts Statement or for other reasons? Please explain why.

Question 8: Are there any other disclosure requirements retained following the review of Topic 820 that should be removed on the basis of the proposed Concepts Statement or for other reasons? Please explain why.

To see how the Board applied the decision questions from the proposed Concepts Statement to Topic 820, see *Decision Questions Considered in Establishing Disclosure Requirements*.

Question 9: How much time would be needed to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by nonpublic business entities be different from the amount of time needed by public business entities? Should early adoption be permitted? If yes to either question, please explain why.

Appendix B — Illustrative Examples

The examples below are reproduced from the proposed ASU (added text is underlined, and deleted text is ~~struck out~~).

Example 9: Fair Value Disclosures

820-10-55-99 The disclosures required by paragraphs ~~820-10-50-1A, 820-10-50-2(a) through (b) and (bbb) through (g)~~, 820-10-50-1E, 820-10-50-2(a) through (b), (bbb) through (d), and (g), 820-10-50-6A, and 820-10-50-8 are illustrated by the following Cases:

a. Assets measured at fair value (Case A)

b. Reconciliation of fair value measurements categorized within Level 3 of the fair value hierarchy (Case B)

c. Information about fair value measurements categorized within Level 3 of the fair value hierarchy (Case C)

d. Fair value measurements of investments ~~in certain entities that calculate~~ that are measured at net asset value per share (or its equivalent) as a practical expedient (Case D).

Case A: Disclosure—Assets Measured at Fair Value

820-10-55-100A A reporting entity might disclose the following for assets to comply with paragraph 820-10-50-2(d). Private companies are exempt from the requirement illustrated below.

[For ease of readability, the table is not underlined as new text.]

($ in millions)	Level 1	Level 2	Level 3
Change in unrealized gains or losses for the period included in earnings (or changes in net assets) for assets held at the end of the reporting period:			
Other revenues	$ 2	$ 4	$ 4
Trading revenues	$ 4	$ 6	$ 2
Change in unrealized gains or losses for the period included in other comprehensive income for assets held at the end of the reporting period	$ 5	$ 3	$ (3)
(Note: For liabilities, a similar table should be presented.)			

Case C: Disclosure—Information about Fair Value Measurements Categorized within Level 3 of the Fair Value Hierarchy

Valuation Techniques and Inputs

820-10-55-103 For fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, this Topic requires a reporting entity to disclose a description of the valuation technique(s) and the inputs used in the fair value measurement. For fair value measurements categorized within Level 3 of the fair value hierarchy, information about the significant unobservable inputs used must be quantitative. A reporting entity is required to provide the range weighted average, and time period used to develop significant unobservable inputs. A reporting entity ~~might~~is required to disclose the following for assets to comply with the requirement to disclose the significant unobservable inputs used in the fair value measurement in accordance with paragraph 820-10-50-2(bbb). Private companies are exempt from the requirement to disclose the range, weighted average, and time period used to develop significant unobservable inputs in the illustration below.

Quantitative Information about Level 3 Fair Value Measurements					
($ in millions)	Fair Value at 12/31/X9	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)	Time Period Used to Develop Unobservable Input
Residential mortgage-backed ~~securities~~security	125	Discounted cash flow	Constant prepayment rate	~~3.5% – 5.5% (4.5%)~~ 5%	19X5–20X9
			Probability of default	~~5% – 50% (10%)~~ 20%	19X5–20X9
			Loss severity	~~40% – 100% (60%)~~ 50%	19X5–20X9
Commercial mortgage-backed securities	50	Discounted cash flow	Constant prepayment rate	3.0% – 5.0% (4.1%)	19X0–20X9
			Probability of default	2% – 25% (5%)	19X0–20X9
			Loss severity	10% – 50% (20%)	19X0–20X9
Collateralized debt obligations	35	Consensus pricing	Offered quotes	20 – 45 (30)	20X9
			Comparability adjustments (%)	-10% – +15% (+5%)	20X9
Direct venture capital investments: healthcare	53	Discounted cash flow	Weighted average cost of capital	7% – 16% (12.1%)	20X9
			Long-term revenue growth rate	2% – 5% (4.2%)	20X9
			Long-term pretax operating margin	3% – 20% (10.3%)	20X9
			Discount for lack of marketability[(a)]	5% – 20% (17%)	20X9
			Control premium[(a)]	10% – 30% (20%)	20X3–20X9
		Market comparable companies	EBITDA multiple[(b)]	10 – 13 (11.3)	20X9
			Revenue multiple[(b)]	1.5 – 2.0 (1.7)	20X9
			Discount for lack of marketability[(a)]	5% – 20% (17%)	20X9
			Control premium[(a)]	10% – 30% (20%)	20X3–20X9
Direct venture capital investments: energy	32	Discounted cash flow	Weighted average cost of capital	8% – 12% (11.1%)	20X9
			Long-term revenue growth rate	3% – 5.5% (4.2%)	20X9
			Long-term pretax operating margin	7.5% – 13% (9.2%)	20X9
			Discount for lack of marketability[(a)]	5% – 20% (10%)	20X9
			Control premium[(a)]	10% – 20% (12%)	20X3–20X9
		Market comparable companies	EBITDA multiple[(b)]	6.5 – 12 (9.5)	20X9
			Revenue multiple[(b)]	1.0 – 3.0 (2.0)	20X9
			Discount for lack of marketability[(a)]	5% – 20% (10%)	20X9
			Control premium[(a)]	10% – 20% (12%)	20X3–20X9
Credit contracts	38	Option model	Annualized volatility of credit[(c)]	10% – 20% (13%)	20X9
			Counterparty credit risk[(d)]	0.5% – 3.5% (2.2%)	20X9
			Own credit risk[(d)]	0.3% – 2.0% (0.7%)	20X9

(a) Represents amounts used when the reporting entity has determined that market participants would take into account these premiums and discounts when pricing the investments.

(b) Represents amounts used when the reporting entity has determined that market participants would use such multiples when pricing the investments.

(c) Represents the range of the volatility curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.

(d) Represents the range of the credit default swap spread curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.

(Note: For liabilities, a similar table should be presented.)

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