

Defining Issues[®]

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Alert

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New Guidance on Measuring Liabilities at Fair Value

Companies determining the fair value of a liability may use the perspective of an investor that holds the related obligation as an asset, according to new FASB guidance that modifies provisions originally in FASB Statement 157.¹ It addresses practice difficulties caused by the tension between fair-value measurements based on the price that would be paid to transfer a liability to a new obligor and contractual or legal requirements that prevent such transfers from taking place.

The new guidance is effective for interim and annual periods beginning after August 27, 2009, and applies to all fair-value measurements of liabilities required by GAAP.² No new fair-value measurements are required by the standard.

The guidance reiterates that the definition of fair value for a liability is the price that would be paid to transfer it in an orderly transaction between market participants at the measurement date. It also reiterates that a company must reflect its own nonperformance risk, including its own credit risk, in fair-value measurements of liabilities and that the liability's nonperformance risk would be the same both before and after the hypothetical transfer on which the fair-value measurement is based.

Measurement

In the absence of a quoted price in an active market for an identical liability at the measurement date, which generally would not be available because liabilities are not exchange-traded as liabilities, companies should use one or more of the following approaches:

- A valuation technique that uses the quoted price of an investment in the identical liability traded as an asset.
- A valuation technique that uses the quoted prices for similar liabilities or the quoted prices for investments in similar liabilities traded as assets.
- Another valuation technique that is consistent with the fair-value measurement principles in accounting standards. The new guidance permits measurements that are based on either the price that the company would pay to transfer the liability at the measurement date or

¹ Accounting Standards Update 2009-05, *Measuring Liabilities at Fair Value*, available at www.fasb.org.

² FASB ASC Topic 820, *Fair Value Measurements and Disclosures*, available at asc.fasb.org.

an estimate of the price a company would pay to transfer the liability based on the price that the company would receive to enter into the liability at that date. Such measurements could be achieved using a valuation technique that is consistent with an income-approach valuation technique (for example, a discounted-cash-flow technique) or a market approach (for example, a recent transaction involving the issuance of a similar liability, adjusted for differences between that transaction and the liability being measured).

Consistent with existing standards, the valuation techniques applied should maximize the use of relevant observable inputs. Inputs should reflect the assumptions that market participants would use or the company's own judgments about market-participant assumptions. Companies measuring the fair value of a liability based on the quoted price of an identical or similar liability traded as an asset in circumstances where the volume and level of activity for the asset has significantly decreased or transactions are not orderly should apply the recently issued guidance for such circumstances.³

Companies are often restricted by creditors from transferring their repayment obligations. No matter which valuation technique a company uses, it should not include a separate input or adjustment to reflect restrictions on its ability to transfer the liability to a new obligor. However, the company still needs to determine whether to make adjustments for factors specific to the asset that do not apply to the fair-value measurement of the liability. The following two circumstances are among those in which a company should consider whether the quoted price of the asset should be adjusted in a liability fair-value measurement:

- The quoted price for the asset relates to a similar, but not identical, liability traded as an asset.
- The unit of account for the investment asset is not the same as for the liability (for example, the quoted price for the asset includes the effect of a third-party credit enhancement).⁴

Fair Value Hierarchy

The FASB's Codification says that a quoted price for a liability in an active market at the measurement date is a "Level 1" fair-value measurement.⁵ The new guidance clarifies that the quoted price for an identical liability traded as an asset in an active market would also be a Level 1 measurement, provided that the quoted price does not need to be adjusted to reflect factors specific to the asset that do not apply to the fair-value measurement of the liability. Any adjustment to the quoted price results in a Level 2 or 3 fair-value measurement.

Example from the New Guidance

This example on the quoted price for a debt obligation is taken from the new guidance with minor modifications.

On January 1, 20X1, Company B issues at par a \$2 million BBB-rated exchange-traded 5-year fixed-rate debt security with an annual 10 percent interest coupon. The Company elects to account for this security under the fair value option. On December 31, 20X1, the security is trading as an asset in an active market at \$929 per \$1,000 after payment of accrued interest. Company B uses the quoted price for the asset in an active market as its initial input for the fair-value measurement of its liability ($\$929 \times 2,000 = \$1,858,000$).

³ FASB ASC 820-10-35-51A through 51H contains the relevant material from FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, available at asc.fasb.org and www.fasb.org.

⁴ For further guidance, see FASB ASC 820-10-35-18A (EITF Issue No. 08-5, *Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement*), available at asc.fasb.org and www.fasb.org.

⁵ *FASB Accounting Standards Codification*TM, available at asc.fasb.org.



In determining whether the quoted price for the asset in an active market represents the liability's fair value, Company B evaluates whether the quoted price for the asset includes the effect of factors not applicable to the fair-value measurement of a liability, for example, whether the quoted price for the asset includes the effect of third-party credit enhancements. Company B determines that no adjustments are required to the quoted price of the asset and concludes that its debt security's fair value at December 31, 20X1, is \$1,858,000. Company B categorizes and discloses the fair-value measurement of its debt security as a Level 1 measurement.

Effective Date and Transition

The new guidance is effective for interim and annual periods beginning after August 27, 2009. Early application is permitted. Companies must disclose in the period of adoption any change in valuation technique caused by applying the new guidance and quantify the effect of the change, if practicable. Revisions to the estimate of a liability's fair value caused by a change in the valuation technique or its application would be included as changes in fair value in the period of adoption.

The descriptive and summary statements in this newsletter are not intended to be a substitute for Accounting Standards Update 2009-05 or any other potential or applicable accounting literature or SEC regulations. Companies applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

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