

## Heads Up

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## Valuation Resource Group Discusses Four Topics at September 22 Meeting.

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The Valuation Resource Group (VRG) was established to provide the FASB staff with information about implementation issues regarding fair value measurements used in financial reporting and the alternative viewpoints associated with those implementation issues. The VRG is composed of a cross-section of industry representatives, including financial statement preparers, auditors, users, and valuation experts. VRG meetings are coordinated by the FASB staff and observed by the SEC, the AICPA, and the PCAOB. The views expressed at the VRG meeting are not authoritative decisions. Authoritative decisions are subject to the FASB's normal, open due process, including open deliberation by the Board.

Greg Forsythe is Deloitte's representative on the VRG. Beth Ann Reese observed the meeting. The notes below represent the authors' interpretations of the discussions held at the September 22, 2009, VRG meeting. The views expressed are not necessarily the views of the authors or of Deloitte. For technical interpretations of Statement 157<sup>1</sup> (ASC 820<sup>2</sup>) and other accounting literature, visit Technical Library: The Deloitte Accounting Research Tool and consider contacting the appropriate accounting or valuation professional.

### Meeting Discussion Notes

#### VRG Issue No. 2009-5: IASB's May 2009 Exposure Draft, *Fair Value Measurement*

**Background:** On May 28, 2009, the International Accounting Standards Board (IASB) issued an exposure draft (ED), *Fair Value Measurement*. Paragraph BC110 of the ED indicates that the IASB used Statement 157 (ASC 820) as its point of departure when developing the ED and that the IASB believes that the ED's guidance is generally consistent with ASC 820. However, paragraph BC110 does identify a few potential differences between the ED's proposed guidance and the current guidance in ASC 820.

**Editor's Note:** For more information about the IASB's ED on fair value measurement, see Deloitte's [June 30, 2009, Heads Up](#).

**Question:** The VRG was asked to provide feedback on some of the potential differences between the ED and ASC 820 that are identified in paragraph BC110 of the ED.

<sup>1</sup> FASB Statement No. 157, *Fair Value Measurements*.

<sup>2</sup> FASB Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures*.

**Discussion:** The VRG voiced concerns about the wording differences between the ED and ASC 820. In particular, the VRG was concerned about those wording differences that the IASB may not have intended.

The following table summarizes the more significant differences between the ED and ASC 820 as well as the VRG members' discussion:

Subject	ED	ASC 820	VRG Members' Discussion
Reference market	Assumes that the transaction takes place in the most advantageous market for the asset or liability. The market in which the reporting entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market.	Assumes that the transaction to sell the asset or transfer the liability occurs in the principal market or, in the absence of a principal market, in the most advantageous market for the asset or liability.	VRG members generally agreed that significant practice issues would not arise in the application of the proposed guidance.
Highest and best use	Includes presentation requirements for circumstances in which an entity uses an asset with other assets in a way that differs from the asset's highest and best use.	No similar presentation requirement.	VRG members generally agreed that this would add an extra layer of work, but no agreement was reached on the added value of the presentation requirement in the ED. They thought the cost-benefit equation might be skewed, but did not think this comes up in practice that often.
Blockage factors	Silent on the unit of account for financial instruments. IAS 39 <sup>3</sup> specifies the unit of account for financial instruments as the individual instrument. This applies to all three levels of the fair value hierarchy.	Specifies the unit of account for financial instruments measured in Level 1 of the fair value hierarchy.	VRG members thought this would cause the most significant difference. They thought that precluding blockage factors for Level 2 and Level 3 fair value measurements would distort the value of the financial instruments.
Valuation premise	Explicitly states that the in-use valuation premise does not apply to financial assets.	Not explicitly addressed.	VRG members discussed the recognition of the portfolio impact, such as for master netting agreements.

## VRG Issue No. 2009-6: Measurement of Core Deposits

**Background:** As part of its project on accounting for financial instruments, the FASB will be considering how to value core deposit liabilities. The FASB staff has proposed that core deposits be defined as deposits without a maturity that are relatively insensitive to interest-rate conditions. The staff identified the following three potential approaches to measuring core deposits: (1) the financial instrument approach, (2) the financial instrument approach with a core deposit intangible, and (3) the face amount approach.

**Question:** The VRG was asked to provide feedback on the "financial instrument" and "financial instrument with an intangible" approaches to measuring core deposits.

**Discussion:** Because VRG members had limited information on these two approaches, their feedback was also limited. Many VRG members stated that the cost savings method was the current method used to measure core deposit intangibles, but cautioned against being too prescriptive about the valuation technique.

<sup>3</sup> IAS 39, *Financial Instruments: Recognition and Measurement*.

Many VRG members were concerned about creating a core deposit intangible outside of a business combination. However, some members thought it might be useful to present this information in the footnotes to the financial statements. They noted that investors want to know the quality of a deposit base and what drives the interest margin.

**Editor's Note:** At its September 23, 2009, Board meeting, the FASB discussed the recognition and measurement of core deposits. The Board did not decide which measurement attribute should be used to measure core deposit liabilities. However, the Board concluded that if it were to decide, on a future date, that such information would be useful to investors, it would support a remeasurement approach with the following characteristics:

- A present value of the average core deposit liability amount discounted by the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity.
- The core deposit liability amount that would be subject to the remeasurement would be determined as an average amount over the implied maturity time period, which would result in the consideration of future deposits. Considering and valuing future deposits would result in an intangible asset's being reflected in the valuation.

### **VRG Issue No. 2009-7: Fair Value of Debt Versus Par Value of Debt When Estimating the Fair Value of an Entity's Equity**

**Background:** Under U.S. GAAP, a reporting entity is often required (or is permitted to elect) to measure the fair value of an entity's equity or debt financial instruments when the fair value of those instruments is not readily determinable (e.g., measuring the fair value of a reporting unit under Statement 142<sup>4</sup> (currently ASC 350<sup>5</sup>) in the determination of whether goodwill may be impaired).

When estimating the fair value of a business or entity, a reporting entity may estimate the fair value of an entity's enterprise (i.e., its debt and equity capital) or an entity's equity capital.

When the equity of an entity is not actively traded on an exchange (i.e., Level 1 inputs are not available), the reporting entity must use a valuation technique to estimate fair value. When estimating the fair value of an entity's equity, reporting entities often use either a direct or indirect method, such as the income approach, the market approach, or both.

When using an indirect method to estimate the equity value of a company, reporting entities estimate the enterprise value and then subtract the value of the entity's debt. General valuation practice has been to subtract the par value of the entity's debt from the fair value of the enterprise to estimate the fair value of equity. Before the current economic environment, this practice was considered a practical expedient in which it was likely that the par value of debt was a reasonable approximation of the debt's fair value in most circumstances.

However, because of the current credit market environment, in which the trading prices for many debt instruments when traded as assets indicate significant discounts from their par value, reporting entities, auditors, and valuation specialists have questioned whether a reporting entity should use the fair value or the par value of debt when measuring the fair value of equity for financial reporting purposes.

**Question 1:** The FASB staff provided two examples to the VRG and asked for feedback on whether the reporting entity should use the fair value or the par value of debt when measuring the fair value of equity for financial reporting purposes.

<sup>4</sup> FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

<sup>5</sup> FASB Accounting Standards Codification Topic 350, *Intangibles — Goodwill and Other*.

The two examples are summarized below:

### **Example 1**

This example illustrated an entity that had one reporting unit with debt outstanding that was actively traded as an asset on an exchange. The par value of the debt exceeded the fair value of the debt on the entity's measurement date. The reporting unit failed step 1 of the ASC 350<sup>6</sup> goodwill impairment test when the fair value and carrying value of the reporting unit's enterprise value were compared and passed step 1 when the fair value and carrying value of the reporting unit's equity value were compared. However, the reporting unit would have failed step 1 if the par value of the debt had been subtracted from the fair value of the enterprise.

### **Example 2**

This example involved three scenarios that were all based on a capital structure for a private company that includes the following three financial instruments:

- Senior debt (assume that the debt is actively traded on an exchange).
- Subordinated debt (assume that the debt is not actively traded and that no other observable inputs are available to estimate fair value).
- Common equity (assume that the equity is not actively traded and that no other observable inputs are available to estimate fair value).

The three scenarios are summarized below:

- *Scenario 1* — Determining the fair value of equity when the fair value of debt is less than the par value of debt.
- *Scenario 2* — Determining the fair value of equity when the fair value of debt is substantially less than the par value of debt and the enterprise value is less than the par value of debt.
- *Scenario 3* — Determining the fair value of subordinated debt (not actively traded) when the enterprise value exceeds the par value of total debt.

**Discussion:** Most VRG members indicated that the answers to the question related to the examples would depend on the facts and circumstances. Because ASC 350 does not explicitly state whether the impairment test should be performed on an enterprise basis or an equity basis, there is diversity in practice. Some VRG members noted that whichever value the reporting entity uses in the calculation (i.e., the fair value or the par value) should be used consistently. In addition, one member noted that the AICPA Impairments Task Force is working to develop the AICPA Impairment Practice Aid.

**Question 2:** The VRG was asked whether valuing an equity interest as a minority interest, rather than as a controlling interest, would change how the value of debt is considered in the valuation of the equity.

**Discussion:** VRG members generally agreed that such valuation would change how the value of debt would be considered in the valuation of the equity because the minority interest does not have control and therefore would not have access to the exit market. However, VRG members cautioned that all facts and circumstances on the control side need to be considered.

## **VRG Issue No. 2009-8: Proposed Accounting Standards Update (ASU) on Improving Disclosures About Fair Value Measurement**

**Background:** On August 28, 2009, the FASB issued an ED of a proposed ASU, *Improving Disclosures About Fair Value Measurements*. The ED is in response to recommendations by several constituents that the current fair value measurement disclosure requirements in ASC 820 (formerly Statement 157) be improved. The ED proposes new, and clarifies

<sup>6</sup> ASC 350 does not explicitly state whether the impairment test should be performed on an enterprise basis or an equity basis.

existing, disclosures about fair value measurements. Similar disclosures are already required by IFRS 7.<sup>7</sup> Comments on the ED are due by October 12, 2009.

**Editor's Note:** For more information about the FASB's ED on improving disclosures about fair value measurements, see Deloitte's [September 1, 2009, Heads Up](#).

**Question:** The VRG was asked to provide input on disclosing the effect of changes in reasonably possible, significant, alternative inputs for Level 3 fair value measurements for each class of assets and liabilities (sometimes also referred to as sensitivity disclosures).

**Discussion:** The following are some concerns raised by VRG members:

- The tracking of these Level 3 inputs is typically a manual process and therefore could be costly to implement.
- It may be difficult to determine what "reasonably possible" means and how it is applied and audited.
- Certain industries, such as private equity investment companies that have significant fair value measurements that are categorized as Level 3, would be significantly affected by these additional disclosures.

<sup>7</sup> IFRS 7, *Financial Instruments: Disclosures*.

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