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## Valuation Resource Group Discusses Four New Topics and Status of Prior Issues at May 8, 2008, Meeting

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### Introduction

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, and Sam Loughry and Adrian Mills observed the meeting. The notes below represent the authors' interpretations of the discussions held at the May 8, 2008, VRG meeting. The views expressed are not necessarily the views of the authors or of Deloitte. For technical interpretations of FASB Statement No. 157, *Fair Value Measurements*, and other accounting literature, visit Technical Library: The Deloitte Accounting Research Tool, and consider contacting the appropriate accounting or valuation professional.

### Meeting Discussion Notes

#### [New Issues Discussed](#)

#### **VRG Issue No. 2008-7: Observable Versus Unobservable Fair Value Measurements in the Current Credit Environment — Factors Affecting the Reliability of an Observable Input**

**Background:** Statement 157 requires that entities use the fair value hierarchy (i.e., Level 1 to Level 3) both to (1) measure fair value and (2) classify fair value measurements for disclosure purposes.

**Measurement** — Fair value measurements should maximize Level 1 and Level 2 inputs (observable inputs) and minimize Level 3 inputs (unobservable inputs). However, Statement 157 indicates that it may sometimes be necessary to adjust a Level 2 input for factors such as the condition or location of a nonfinancial asset or liability relative to the input price, the comparability of the terms of an asset or liability, and the liquidity in the market for the asset or liability.

*Classification* — If the entity makes an adjustment to the Level 2 input that is not based on or corroborated by observable market data, and if that adjustment is significant to the fair value measurement in its entirety, the measurement is considered a Level 3 measurement. Statement 157 indicates that entities need to use judgment in determining whether an adjustment is significant. Statement 157 requires additional disclosures for Level 3 fair value measurements.

**Question:** The VRG was asked to provide its insights on the following questions about certain measurement and classification issues:

- *Timing of transaction data* — How should one assess whether transaction data are stale and therefore whether they should be adjusted to reflect current market participant assumptions?
- *Size or volume of activity in the principal or most advantageous market* — How should one assess whether the volume of activity is so thin (i.e., insufficient) that it essentially becomes unreliable?
- *Assessment of a “forced transaction”* — Paragraph 7 of Statement 157 indicates that a fair value measurement is an orderly transaction and therefore is not a forced transaction (e.g., a forced liquidation or distress sale). Can recent pricing information be considered a forced transaction when there are a number of competitive bidders for the asset? Does a regular and observable level of these forced transactions inherently make the pricing information reliable for measurement purposes?

**Discussion:** Many VRG members acknowledged that the staleness (level of activity) and volume of the transaction data are factors in determining whether a Level 2 input should be adjusted for measurement purposes and that if that adjustment were significant, the measurement would fall into Level 3. In addition, many VRG members suggested that it would be difficult to provide specific guidance on this topic since the factors and weighting of those factors might differ depending on the nature of the asset and other facts and circumstances. They indicated that standard-setting efforts in this area would most likely result in additional rules.

Regarding forced transactions, VRG members generally indicated that market data should be used to determine fair value even if the market is not in “balance” because there are many sellers and a limited number of buyers. However, some VRG members suggested that market data may sometimes represent forced (distressed) sales and that it is often difficult to analyze (look through) these data to determine whether the underlying transactions represent forced or distressed sale transactions (at the entity level) that would be discarded or adjusted. Some VRG members indicated that they look to the guidance in the Center for Audit Quality (CAQ) white paper “Fair Value Measurements in Illiquid (or Less Liquid) Markets.”

#### **VRG Issue No. 2008-8: Determining Whether a Discount Should Be Applied for a Restriction on Sale**

**Background:** Paragraph 6 of Statement 157 indicates that a fair value measurement takes into account “**attributes specific to the asset or liability**, including the condition and/or location of the asset or liability and **restrictions, if any, on the sale or use of the asset** at the measurement date.” [Emphasis added] Paragraphs A28–A30 of Statement 157 contain examples illustrating the application of the Statement’s guidance on fair value measurements of restricted assets. To apply this guidance, the reporting entity must determine whether the restriction is an attribute of the asset (i.e., the restriction would transfer to a market participant) or an attribute of the reporting entity (i.e., the restriction would not transfer with the asset to a market participant).

The VRG was asked to discuss the following four examples of restricted assets:

- Underwriting agreements for public offerings of securities often contain “lock-up” provisions that prohibit the sale of the entity’s securities by the entity issuing the securities, its founders, directors, executive officers, venture capitalists, and others for a specified period.
- Some investing entities may also hold a seat or seats on the investee’s board of directors (or otherwise possess insider information about the investee) and thus may be subject to restrictions on the sale of the investment by regulators during certain times (so-called blackout restrictions).
- Debt agreements can require that the borrower post its assets (e.g., U.S. Treasury securities) as collateral. The borrower still retains the collateral on its balance sheet, but the collateral might be considered restricted since it cannot be sold while it is collateral for the borrowing. Is a restriction on the sale of an asset that is collateral for a borrowing an attribute of the asset?
- Not-for-profit organizations often receive contributions of personal property (e.g., food, clothing, or other necessities). Such gifts are referred to as “gifts-in-kind.” Sometimes the donor may restrict the distribution of the gifts-in-kind. Gifts-in-kind are initially measured at fair value (as contributions received) under FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*.

**Question:** For each example, is the restriction an attribute of the asset that an entity should consider when measuring its fair value under Statement 157?

**Discussion:** Although the VRG was asked to discuss the four examples above, the discussion focused on Statement 157’s principle regarding the treatment of restrictions in a fair value measurement and whether that principle should be clarified. VRG members’ viewpoints were on opposite ends of the spectrum. Some interpreted the principle in Statement 157 as requiring a reporting entity to include **all** restrictions when valuing an asset, whether the restrictions are attributes of the asset or the entity. On the other end of the spectrum, some believed that the fair value measurement should only take into account specific restrictions on the instrument itself. Others indicated that only contractual restrictions should be considered.

One member indicated that fair valuing an asset with a restriction on sale was similar to fair valuing a liability with a restriction on transfer. If it is illegal to sell an asset, then there is no principal market for the asset. The VRG indicated that many preparers are uneasy about the development of a hypothetical market for a transaction that cannot occur as a result of the restriction. Others indicated that while they believe a discount for liquidity may be appropriate, there is no guidance on how to measure that discount.

Several VRG members indicated that there appear to be differing practices regarding discounts for restrictions on the sale of assets in fair value measurements and that further guidance would be appropriate.

#### **VRG Issue No. 2008-9: Employee Benefit Plans**

**Background:** Employee benefit plans often permit plan participants to make loans to themselves (secured by the participant’s plan account balance). The AICPA Audit and Accounting Guide *Employee Benefit Plans* (the “employee benefit plan guide”) indicates that participant loans are investments and that they thus should be reported at fair value. Before Statement 157, the predominant practice was to consider the loan’s carrying value (i.e., the net realizable value determined as the loan’s unpaid principal amount less any valuation reserve for uncollateralized or unrealizable amounts) an approximation of its fair value. The fair value under Statement 157 would most likely differ from the loan’s net realizable value. This might be because, for example, a fair value measurement under Statement 157 would take into account the stated rate of interest compared with the current market rate of interest for a borrower of comparable credit standing.

**Question:** How should employee benefit plans determine the fair value of participant loans under Statement 157?

**Discussion:** The FASB staff and VRG members indicated that this Issue may be best addressed by standard setting that addresses the measurement attribute of participant loans under the employee benefit plan guide. The AICPA observer at the VRG meeting indicated that the AICPA would consider whether this Issue, and potentially others that have been identified as part of the AICPA's efforts to update the employee benefit plan guide, should be brought to the FASB for potential standard setting.

#### **VRG Issue No. 2008-10: Contingent Liabilities**

**Background:** Under U.S. GAAP, entities are currently required to measure contingent liabilities at fair value in certain limited circumstances. One example is the initial recognition of a written guarantee within the scope of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (assume that no premium was received). FASB Statement No. 141(R), *Business Combinations*, will broaden the fair value measurement attribute to include (1) all contractual contingencies and (2) noncontractual contingencies that the entity determines are more likely than not to occur and to result in an asset or liability that exists as of the acquisition date as defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

The VRG was informed that currently there are limited market data (i.e., observable data) to use in valuing contingent liabilities. Typically, entities measure the fair value of a contingent liability by using an expected value computation that takes into account the mean distribution of outcomes while assuming a normal distribution. However, contingencies by definition often do not have a normal distribution (e.g., a lawsuit may have a binary distribution — that is, the outcomes are to either win or lose the lawsuit).

**Question:** The VRG was asked to comment on current practice for determining the fair value of contingent liabilities.

**Discussion:** VRG members agreed that fair valuing a contingent liability to be recorded in the balance sheet is sometimes required for financial reporting (this requirement will be expanded under Statement 141(R)), but that a single, "point estimate" amount recorded in the balance sheet is not sufficient information for an investor. An investor also needs disclosure regarding how the single amount was calculated, a range of the possible outcomes, and qualitative disclosure regarding the risks related to the uncertainty that were considered in the estimated outcomes used to develop the range and the single estimate. Some VRG members questioned whether fair value under Statement 157 is the appropriate measurement attribute for contingent liabilities.

#### **Status of Issues Discussed by the VRG at Prior Meetings**

The FASB staff briefly updated the VRG on the status of each of the prior VRG Issues and indicated whether standard setting by the FASB or EITF is in process, will be considered in the near future, or is not planned for the Issue.

#### **VRG Issues No. 2007-1: Fair Value of Mortgage Loans and No. 2007-2: Unit of Account — Decomposition of an Asset**

**Background:** At the October 1, 2007, meeting, the VRG was asked to consider how entities should apply Statement 157's fair measurement guidance to loans measured at fair value when the holder of the loans generally bundles and sells the loans in the securitization market. The price for the loan in the securitization market might differ from the price received if the entity were to sell the loans in the "whole-loan" market.

**Update:** No standard setting is planned for this Issue. The FASB staff indicated that it brought the Issue to the Board for consideration and that the Board did not believe standard setting was necessary. The FASB staff added that during those discussions,

some Board members believed that entities generally should value what they currently have (unsecuritized loans), not what they will have in the future (securitized loans). The FASB staff concluded by adding that if circumstances warrant valuing what an entity will have in the future (i.e., unsecuritized loans as securitized loans), the entity should adjust that price for the cost of transforming the asset and any profit margin that a market participant would demand.

### **VRG Issue No. 2007-3: How to Factor Liquidity Into Fair Value Measurements**

**Background:** Certain financial markets are suffering from a lack of liquidity. There are differing opinions about how the lack of liquidity should be factored into a fair value measurement. Some have indicated that prices of assets traded in very thin markets that were historically active may reflect forced sales rather than arm's-length transactions. The VRG was asked whether overall market illiquidity should affect fair value measurements.

**Update:** No standard setting is planned for this Issue. At its October 1, 2007, meeting, the VRG indicated that it would be difficult to provide principles-based guidance. The FASB staff agreed with this assessment and decided not to bring the Issue to the Board. However, during the May 8, 2008, VRG meeting, the FASB staff indicated that it is still receiving questions about this Issue. Therefore, the FASB staff decided to discuss this Issue again to understand whether there is diversity in practice. See the discussion of [Issue No. 2008-7: Observable Versus Unobservable Fair Value Measurements in the Current Credit Environment](#) in the "New Issues Discussed" section above.

**Editor's Note:** The CAQ issued three white papers addressing key accounting issues resulting from the current turbulent conditions in the credit markets. The papers focus on three issues:

- [Fair value measurements in illiquid \(or less liquid\) markets.](#)
- [Consolidation of commercial paper conduits.](#)
- [Accounting for underwriting and loan commitments.](#)

### **VRG Issue No 2007-4: Elements of Consideration for Determination of "Active Market"**

**Background:** The term "active market" is not well defined in the accounting or valuation literature. Under Statement 157, Level 1 inputs are observable market inputs that reflect quoted prices for identical assets or liabilities in active markets. The determination of whether a market is active is critical in applying Statement 157's measurement (and disclosure) guidance, since quoted prices in active markets for identical assets must be used (unadjusted) to price an asset. Statement 157 indicates that an active market is a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. At the October 1, 2007, meeting, the VRG was asked whether additional guidance on what constitutes an active market is necessary.

**Update:** No standard setting is planned for this Issue. At the October 1, 2007, meeting, the VRG indicated that it would be difficult to provide principles-based guidance. During the May 8, 2008, VRG meeting, the FASB staff agreed with that assessment and indicated that it does not plan to submit a FASB agenda request for this Issue. See also discussion of [Issue No. 2008-7: Observable Versus Unobservable Fair Value Measurements in the Current Credit Environment](#) in the "New Issues Discussed" section above.

### **VRG Issue No. 2007-5: Determination of Principal Market**

**Background:** Paragraph 8 of Statement 157 defines the principal market as "the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability." At the October 1, 2007,

meeting, the VRG was asked to consider whether, in situations in which the entity has access to multiple markets, the determination of the principal market should be based on **entity-specific** or **market-based** volume and activity.

**Update:** No standard setting is planned for this Issue. On the basis of input received at the October 1, 2007, meeting, the FASB staff does not believe there will be significant diversity in practice in this area and therefore believes that there is no need for standard setting in this area at this time. The FASB staff indicated that it will continue to monitor this Issue for diversity that may arise because of the adoption of Statement 157 for nonfinancial assets and nonfinancial liabilities.

**VRG Issues No 2007-6: Highest and Best Use: Defensive Value and No. 2008-1: Accounting for an Asset That the Acquirer Does Not Intend to Use or Intends to Use in a Way Other Than Its Highest and Best Use**

**Background:** Defensive value was discussed at the October 1, 2007, and February 1, 2008, meetings. At the October 1, 2007, meeting, the VRG indicated that certain intangible assets that an entity acquires in a business combination, but does not intend to use, may have value to market participants. This value may be created by (1) the market participant's intent and ability to use the asset or (2) denying other market participants access to the asset (i.e., locking up the asset). At the February 1, 2008, meeting, the VRG explored measuring and subsequently accounting for defensive value assets in the context of an entity acquiring a trademark in a business combination that it intends to (1) phase out over a one-year period and then retire and (2) deny other market participants access to for defensive reasons.

**Update:** The FASB staff indicated that it intends to submit an agenda request to the FASB chairman to address the subsequent accounting for defensive value assets. Some VRG members indicated that they believe there will also be diversity in practice regarding the measurement of the asset. However, it was agreed that whether diversity exists will not be known until the adoption of Statement 141(R).

**Editor's Note:** For more information about the VRG's previous discussion of this topic, see Deloitte's [February 20, 2008, Heads Up](#).

**VRG Issue No. 2007-7: Assets Acquired Through an Auction**

**Background:** Statement 157 clarifies the definition of fair value to indicate that the fair value of an asset is the price that would be received when the asset is sold in an orderly transaction between market participants as of the measurement date. In an auction, the winning bidder prevails by offering a higher price than that offered by the other auction participants. Some might interpret Statement 157's market participant guidance and exit price principle as implying that the winning bidder should immediately reduce the fair value of its asset to the bid of the next highest bidder in the auction that just occurred. At the October 1, 2007, meeting, the VRG was asked how the market participant view should be applied in the determination of fair value in auction scenarios.

**Update:** No standard setting is planned for this Issue. The FASB staff believes that standard setting is not necessary since there is unlikely to be significant diversity in practice. VRG members generally seem to agree that entities may use the winning bid as a data point in a fair value measurement unless market participants no longer consider the winning bid to be a relevant data point.

**VRG Issue No 2007-8: Assets and Liabilities Without Markets**

**Background:** When actual markets do not exist for the sale or transfer of a particular asset or liability, an entity must determine fair value by constructing a hypothetical exit market that takes into account the characteristics of market participants that would transact in that market. At the October 1, 2007, meeting, the VRG focused on measuring liabilities that cannot be transferred because of restriction.

**Update:** The FASB staff indicated that this Issue is addressed by proposed FASB Staff Position No. FAS 157-c, “Measuring Liabilities Under FASB Statement No. 157,” which was recently exposed for public comment and is being redeliberated by the FASB. Restricted assets are discussed further in [VRG Issue No. 2008-8: Determining Whether a Discount Should Be Applied for a Restriction on Sale.](#)” See discussion of Issue 2008-8 in the “New Issues Discussed” section above.

#### **VRG Issue No. 2007-9: Pension Plan Disclosures**

**Background:** At its October 1, 2007, meeting, the VRG was asked to consider whether Statement 157’s disclosure requirements apply to pension assets disclosed in the plan sponsor’s financial statements.

**Update:** The FASB staff indicated that the Board has concluded that the disclosures in Statement 157 do not apply to fair value measurements of the plan sponsor’s plan assets. However, the Board directed the FASB staff to include disclosure requirements about fair value measurements, similar to those required by Statement 157, in proposed [FASB Staff Position No. FAS 132\(R\)-a, “Employer’s Disclosures About Postretirement Benefit Plan Assets.”](#) The comment period for the proposed FSP ended on May 2, 2008. If the proposed FSP is finalized, its disclosures about plan assets will be applied prospectively for fiscal years ending after December 15, 2008.

#### **VRG Issue No 2007-10: Use of Net Asset Value in Fund-of-Funds Investments**

**Background:** Investment funds within the scope of the AICPA Audit and Accounting Guide *Investment Companies* typically report net asset value (NAV) to investors periodically as the per-share fair value of the fund or as the total value of a partnership interest. Reporting entities typically receive these NAV quotes from the general partner or fund manager. The VRG was asked whether NAV equals fair value for an investment in a closed-end investment fund that does not trade in an active market or an alternative investment fund (e.g., a hedge fund, private equity, or fund of funds). At the October 1, 2007, meeting, the VRG generally indicated that NAV may not represent fair value as defined by Statement 157 (e.g., because of restrictions on selling or liquidating the investment). However, several VRG members indicated that most preparers use NAV to measure fair value and that this would be a significant change in practice.

**Update:** No standard setting is planned for this Issue. However, the FASB staff indicated that the measurement of assets with restrictions on sales is being further discussed in [VRG Issue No. 2008-8: Determining Whether a Discount Should Be Applied for a Restriction on Sale.](#) See discussion of Issue No. 2008-8 in the “New Issues Discussed” section above.

#### **VRG Issue No. 2007-11: Fair Value of a Liability With Third-Party Guarantees**

**Background:** Issuances of debt can include a third-party guarantee that enhances the credit standing of the debt instrument. For example, the issuer of a debt security may obtain a financial guarantee from an unrelated third party that guarantees the issuer’s payment obligations for the benefit of the holder of the debt security. At the November 9, 2007, meeting, the VRG was asked to consider whether the issuer of the debt needs to consider the effect of the third-party guarantee when measuring the liability at fair value under Statement 157.

**Update:** The FASB staff indicated that this Issue has been added to the EITF’s agenda. A summary of the Issue (including potential views on how to resolve it) is available in the [EITF Agenda Committee minutes](#) of the upcoming June 12, 2008, EITF meeting on the FASB’s Web site.

#### **VRG Issue No 2007-12: Highest and Best Use — Land Example**

**Background:** Example 2 in Appendix A of Statement 157 depicts a situation in which a reporting entity acquires land that was developed for industrial use in a business combination. The reporting entity determines that the highest and best use of the land



to a market participant would be as a vacant site sold rather as a site for a manufacturing facility, even though the entity's intent is to continue using the manufacturing facility. The VRG was presented these facts and was asked to determine how fair value should be allocated to the land and property improvements (i.e., the manufacturing facility).

**Update:** No standard setting is planned for this Issue. At the October 1, 2007, meeting, the VRG observed that the value of the improvements would be based on the "in-exchange" valuation premise. This may lead to a counterintuitive outcome in which a significant amount would be allocated to land and less to the property improvements. The FASB staff indicated that on the basis of the discussions, it did not believe that there was going to be diversity in practice. At the May 8, 2008, meeting, some VRG members indicated that the example was used to illustrate a theoretical point and that they did not believe that this situation would occur very often in practice.

#### **VRG Issue No. 2007-13: Definition of "Significant" in Evaluating Inputs for Fair Value Hierarchy Classification**

**Background:** Statement 157 indicates that entities must classify a fair value measurement within the hierarchy on the basis of the lowest-level input that is significant to the fair value measurement in its entirety and that determining whether an input is significant requires judgment. At the November 9, 2007, meeting, the VRG was asked to comment on how the significance of an input is assessed in practice.

**Update:** No standard setting is planned for this Issue. At the November 9, 2007, meeting, the VRG indicated that this is a facts-and-circumstances assessment for which further standard setting would not be appropriate. At the May 8, 2008, meeting, the FASB staff agreed with this assessment. This Issue is similar to [VRG Issue No. 2008-7: Observable Versus Unobservable Fair Value Measurements in the Current Credit Environment](#). See the discussion of Issue 2008-7 in the "New Issues Discussed" section above.

#### **VRG Issue No 2007-14: Accounting for Transaction Costs in Determining the Fair Value of an Investment**

**Background:** Statement 157 indicates that transaction costs are not an attribute of an asset (therefore, they are not considered in the fair value of the asset) and should be accounted for in accordance with other GAAP. Paragraph 1.06 of the AICPA Audit and Accounting Guide *Investment Companies* (the "Guide") states, in part, "Investment companies discussed in this Guide are required to report their investment assets at fair value . . . ." Entities within the scope of the Guide are required to initially record investments at cost (i.e., the entry price), including related commissions and other charges that are part of securities purchase transactions (transactions costs), with a subsequent measurement at fair value. Available-for-sale securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, are also subsequently measured at fair value. However, Statement 115 does not address the initial measurement. Historically, some preparers have interpreted the initial measurement to be cost while others have expensed the transaction costs. The VRG was asked whether the adoption of Statement 157 should cause entities to exclude transaction costs from initial measurement for these investments.

**Update:** No standard setting is planned for this Issue. At the November 8, 2007, meeting, many VRG members indicated that the adoption of Statement 157 does not change measurements prescribed by other GAAP. At the May 8, 2008, meeting, the FASB staff indicated that it believes that entities should not, as a result of the adoption of Statement 157, change their policy for the treatment of initial measurements for (1) investments accounted for under the Guide or (2) available-for-sale securities under Statement 115.



### **VRG Issue No 2008-2: Overlapping Customer Relationships**

**Background:** The VRG was asked whether overlapping customer relationships acquired in a business combination should be recognized as intangible assets apart from goodwill.

**Update:** No standard setting is planned for this Issue. At the February 1, 2008, meeting, the VRG indicated that there was some diversity in practice regarding measurement of overlapping customer relationships. During the May 8, 2008, meeting, it was noted that the Appraisal Foundation has established a working group to address the measurement of customer relationships.

### **VRG Issue No. 2008-3: Valuation of Intangible Assets Using the “Current Replacement Cost” Method**

**Background:** At the February 1, 2008, meeting, VRG members considered whether the current replacement cost method is calculated on a pretax or an after-tax basis. During that meeting, some members indicated that there may be confusion in practice about the technical aspects of the cost approach, and in particular, the current replacement cost method. The current replacement cost method establishes value according to the cost of reproducing or replacing the asset. At that meeting, the VRG members generally agreed that this calculation should be pretax because capital investments are recorded gross of tax. VRG members noted that some practitioners fail to tax-affect certain valuation methods because they believe they are applying a “cost approach” even though they are applying another valuation approach. For example, some confuse the “cost” savings and “cost” avoidance methods as forms of the cost approach. The cost savings and cost avoidance methods are forms of the income approach, which should be tax-affected. This is because these methods are developed by using period costs that would be avoided, not an investment that is recouped over time. In addition, these methods would need to take into account the benefit from the tax amortization as a component of the fair value estimate.

**Update:** No standard setting is planned for this Issue. Some VRG members indicated that the valuation profession and the accounting profession should take steps to educate their constituencies about this Issue.

### **VRG Issue No 2008-4: Meaning of “Legally Permissible” in Assessing the Highest and Best Use**

**Background:** VRG members were asked whether the term “legally permissible,” as used in paragraph 12 of Statement 157, means permissible as of the measurement date or whether it can be more broadly interpreted to mean permissible in the future.

**Update:** No standard setting is planned for this Issue. At the February 1, 2008, meeting, the VRG indicated that a broad interpretation was reasonable; however, a valuation would take into account the risks associated with transforming an asset into a different state. The VRG did not believe there was diversity in practice. During the May 8, 2008, meeting, the FASB staff agreed with this assessment and decided not to bring the Issue to the Board.

### **VRG Issue No 2008-5: Fair Value of Inventory**

**Background:** When finished goods inventory is acquired in a business combination under Statement 141(R), the acquired inventory should be measured at fair value under Statement 157. The VRG was asked, with respect to Statement 157’s exit price notion and highest-and-best-use concept, how one should determine the fair value of finished goods inventory.

**Update:** No standard setting is planned for this Issue. At the February 1, 2008, meeting, the VRG indicated that the fair value should be close to the net realizable value, which allows the acquirer to realize a profit on the selling effort. The VRG believes that this is supported by paragraph A24(f) of Statement 157. The FASB staff agreed with this assessment and decided not to bring the Issue to the Board.

## **VRG Issue No. 2008-6: Allocation of Portfolio-Based Credit Adjustments for Hedge Effectiveness Testing**

**Background:** Market participants would consider counterparty credit risk in pricing a derivative contract. Therefore, under Statement 157, an entity's valuation method should incorporate the effect of credit risk on fair value. For entities that have multiple derivative contracts under a master netting agreement, the credit adjustment typically is estimated at the derivative portfolio level on a net basis by counterparty. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires that hedge effectiveness be assessed for each hedging relationship (i.e., not at the portfolio level). Statement 133 Implementation Issue No. G10, "Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative," states that "a change in the creditworthiness of the derivative's counterparty in a fair value hedge would have an immediate impact [in assessing hedge effectiveness] because that change in creditworthiness would affect the change in the derivative's fair value." Accordingly, the credit adjustment may be allocated to individual derivatives for hedge effectiveness testing. At the February 1, 2008, meeting, the VRG was asked to consider how portfolio-based credit adjustments on a portfolio of derivatives should be allocated to individual derivatives in the portfolio.

**Update:** No additional standard setting is planned. The FASB staff indicated that the SEC staff has informally addressed this Issue at the request of the Financial Executives Institute.

**Editor's Note:** Deloitte's [Financial Reporting Alert 08-8, \*Consideration of Credit Risk in Fair Value Hedge Effectiveness Assessments\*](#), summarizes the SEC staff's view as follows:

Reporting entities can exclude credit risk from their periodic quantitative fair value hedge effectiveness assessments when they determine qualitatively that credit risk would not cause the hedging relationship to fail its periodic effectiveness assessment.

When a reporting entity cannot or does not determine qualitatively that credit risk would not cause the hedging relationship to fail its periodic effectiveness assessment, it must include credit risk in its periodic quantitative assessments of fair value hedging relationships. Statement 133 requires reporting entities to perform this assessment at the individual hedge relationship level (i.e., individual derivative level). If the reporting entity, in its determination of fair value of its derivatives, estimates a credit adjustment at a portfolio level, the following four methods are considered acceptable alternatives for allocating the portfolio-level credit adjustment to the individual derivative unit [methods omitted].

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