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Valuation Resource Group Discusses Four Topics at April 12 Meeting

by Beth Ann Reese, Deloitte & Touche LLP, and Greg Forsythe, Deloitte Financial Advisory Services LLP

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 meetings 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 April 12, 2010, VRG meeting. The views expressed are not necessarily the views of the authors or of Deloitte. For technical interpretations of ASC 820[1] (formerly Statement 157[2]) and other accounting literature, visit Technical Library: The Deloitte Accounting Research Tool and consider contacting an appropriate accounting or valuation professional.

Meeting Discussion Notes

VRG Issue No. 2010-01: FASB's and IASB's Joint Project on Fair Value Measurement and Disclosure

Background: The FASB and IASB have agreed to develop converged fair value guidance. The FASB staff noted that the tentative plan is to issue an exposure draft of this guidance by the end of May 2010; comments would be due by August 16, 2010. The fair value measurement requirements under U.S. GAAP are expected to be the same as those under IFRSs, except for minor style differences and differences related to the U.S. GAAP guidance on net asset value per share.[3]

Question: The VRG was asked to provide feedback on whether any of the tentative decisions reached in the joint project on fair value measurements would represent a significant change in practice or would result in unintended consequences.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[2] FASB Statement No. 157, *Fair Value Measurements*.

[3] U.S. GAAP will retain the guidance in FASB Accounting Standards Update No. 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, on measuring the fair value of certain alternative investments. This guidance offers investors a practical expedient for measuring the fair value of investments in certain entities that calculate net asset value per share. The IASB is not including this guidance.

Discussion: The VRG voiced concerns regarding some of the tentative decisions — in particular, those on blockage factors. The following table summarizes (1) the boards' tentative decisions to date that the FASB staff believes will change the existing guidance in ASC 820 (though these decisions may not necessarily result in a change in practice) and (2) the VRG members' discussion:

Subject	Tentative Board Decisions That Would Change Existing Guidance in ASC 820	VRG Members' Discussion
The principal (or most advantageous) market	• The reference market for a fair value measurement is the principal (or most advantageous) market, provided that an entity has access to that market. • The principal market is the market with the greatest volume and level of activity for the asset or liability. • The principal market is presumed to be the market in which the entity normally transacts. An entity does not need to perform an exhaustive search for markets that might have more activity than the market in which the entity normally transacts. • The determination of the most advantageous market takes into account both transaction costs and transportation costs.	Some VRG members expressed concern about adding the **access** notion to the "principal or most advantageous market" principle. They pointed out that this could result in unintended consequences, particularly when there is no or a limited market. They also highlighted that a price in a market that an entity does not have access to can sometimes still be a relevant observable input that the entity could consider in estimating fair value.
Market participants	• In the description of market participants, "independence" means that market participants are independent of each other (i.e., they are not related parties). • A price in a related-party transaction may be used as an input to a fair value measurement if the transaction was entered into at market terms. • The unobservable inputs derived from an entity's own data, adjusted for any reasonably available information that market participants would take into account, are considered market-participant assumptions and meet the objective of a fair value measurement.	VRG members expressed concern that the guidance on related parties was circular. They pointed out that to use the price from the related-party transaction, an entity would have to prove it was at market terms (in which case the entity would not need the price from the related-party transaction). Some VRG members indicated their belief that the guidance on related parties should take into account existing related-party literature, such as ASC 850-10-50-5, which states, "Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist" and "Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated."

Some VRG members expressed concern about adding the access notion to the "principal or most advantageous market" principle.

Some VRG members were concerned about eliminating the in-use concept for financial assets because it might lead to a conclusion that investment companies cannot include control premiums when valuing controlling interests in portfolio companies.

Subject	Tentative Board Decisions That Would Change Existing Guidance in ASC 820	VRG Members' Discussion
Highest and best use	• The highest-and-best-use concept only relates to nonfinancial assets, not to liabilities or financial assets. • The terms "physically possible," "legally permissible," and "financially feasible" will be defined.	Some VRG members noted that, in certain circumstances, nonfinancial assets can be bundled as a group with financial instruments to offset the risk of another asset or liability that is not measured at fair value (e.g., an inventory purchase contract). Some VRG members were concerned about eliminating the in-use concept for financial assets because it might lead to a conclusion that investment companies cannot include control premiums when valuing controlling interests in portfolio companies. The VRG also noted that more guidance on what is considered a nonfinancial asset and liability would be helpful.
Incremental value	• Entities would be required to disclose information about when they use an asset in a way that differs from its highest and best use.	VRG members had questions about when the disclosure would be required. Specifically, they asked whether entities would need to disclose this information only when a subsequent measurement at fair value occurs (e.g., because the asset is measured at fair value on a recurring basis or has been impaired to its fair value) or whether they would also need to do so at other times (e.g., at initial recognition in a business combination). The FASB staff noted that it would need to further consider when the disclosure should be required.
Valuation premise	• The concept of a valuation premise only relates to nonfinancial assets, not to liabilities or financial assets. • The objective of measuring an individual asset at fair value is to determine the price for a sale of that asset alone, not for a sale of that asset as part of (1) a group of assets or (2) a business. However, when the highest and best use of an asset is as part of a group of assets, the fair value measurement of that asset presumes that the sale is to a market participant that has, or can obtain, the "complementary assets" and "complementary liabilities." Complementary liabilities include working capital but do not include financing liabilities. • The objective of the valuation premise will be described without using the terms "in-use" and "in-exchange" because those terms are often misunderstood.	Many VRG members expressed concern that the revisions to the guidance on groups of assets could have significant implications for current practice, cause unnecessary confusion, or both.

VRG members agreed about the need for additional guidance on the compensation a market participant would demand for taking on an obligation — in particular for nontraded liabilities.

<table>
<tr><th>Subject</th><th>Tentative Board Decisions That Would Change Existing Guidance in ASC 820</th><th>VRG Members' Discussion</th></tr>
<tr><td>Application to liabilities</td><td>The compensation a market participant would demand for taking on an obligation to apply a present value technique will be described in the guidance.
The transfer of a liability assumes that a market-participant transferee has the knowledge and ability to fulfill the identical obligation.
What nonperformance risk represents in addition to credit risk will be clarified.</td><td>VRG members agreed about the need for additional guidance on the compensation a market participant would demand for taking on an obligation — in particular for nontraded liabilities.</td></tr>
<tr><td>Measuring an entity's own equity instruments at fair value</td><td>Guidance on measuring the fair value of an entity's own equity instruments will be included in a converged fair value measurement standard. That is, a reporting entity should measure the fair value of its equity instrument from the perspective of a market participant that holds the instrument as an asset.</td><td>No significant VRG discussion.</td></tr>
<tr><td>Measuring the fair value of financial instruments</td><td>The guidance on valuation adjustments from the IASB's Expert Advisory Panel report, Measuring and Disclosing the Fair Value of Financial Instruments in Markets That Are No Longer Active, will be included.</td><td>No significant VRG discussion.</td></tr>
<tr><td>Measuring the fair value of financial instruments within a portfolio</td><td>An exception to fair value measurement principles will be permitted. Entities will be allowed to use midprices as a basis for establishing fair values to offset market risk positions (e.g., interest rate risk, currency risk, or other price risk) and to apply the price within the bid-ask spread that is most representative of fair value to the net open risk position. To use this exception, an entity must:
Manage its financial instruments on the basis of the net open risk position in accordance with the entity's documented risk management strategy.
Manage the net open risk position in a consistent manner from period to period.
In addition:
The market risks that are being offset must be substantially the same.
The financial instruments must share common characteristics.
The financial instruments must be measured at fair value on a recurring basis.
Entities are permitted to consider offsetting counterparty credit risk positions when measuring the fair value of financial instruments when there is a legally enforceable right of offset (e.g., a master netting agreement) with the counterparty in the event of default.</td><td>No significant VRG discussion.</td></tr>
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Subject	Tentative Board Decisions That Would Change Existing Guidance in ASC 820	VRG Members' Discussion
Premiums and discounts in a fair value measurement	• Blockage factors will be clarified and a description of how they differ from other types of adjustments, such as a lack of marketability discount, for an individual instrument will be included. • The application of a blockage factor will be prohibited at any level of the fair value hierarchy. • There would be guidance specifying that a fair value measurement in Levels 2 and 3 of the fair value hierarchy takes into account other premiums and discounts that market participants would consider in pricing an asset or liability at the unit of account specified in the relevant standard (except for a blockage factor).	VRG members thought that this was a significant change in practice. Concerns were raised regarding the use of the term "lack of marketability discount," since they did not believe this term was understood in practice. This term has historically applied to minority interests in privately held stocks. Some VRG members voiced concern about the proposal to preclude the consideration of blockage in Levels 2 and 3 of the fair value hierarchy. Some VRG members noted that blockage discounts typically apply to market transactions for assets that do not relate to Level 1 fair value measurements (e.g., a fleet of cars). They believed that it would be challenging to distinguish a blockage discount from a liquidity and marketability discount.
Disclosures about fair value measurements	• Entities would be required to disclose fair value information by level in the fair value hierarchy for items that are not measured at fair value in the statement of financial position. • A sensitivity analysis disclosure would be required for all Level 3 fair value measurements unless another standard besides ASC 820 exempts such a disclosure. The objective of the sensitivity analysis disclosure is to provide financial statement users with information about measurement uncertainty for Level 3 fair value measurements. That is, the disclosure does not represent a worst-case scenario and is not forward-looking. In addition, the sensitivity analysis disclosure should take into account the effect of the correlation between inputs when relevant.	No significant VRG discussion.

Some VRG members voiced concern about the proposal to preclude the consideration of blockage in Levels 2 and 3 of the fair value hierarchy.

VRG Issue No. 2010-02: Fair Value Measurement of Leased Investment Properties

Background: At the January 20, 2010, joint board meeting, the FASB and IASB tentatively decided, in discussing their joint project on leases, that a lessor of investment properties would be required to apply the proposed new lessor accounting requirements if the lessor measures its investment properties at cost. The IASB tentatively decided that if a lessor of investment properties measures its investment properties at fair value in accordance with IAS 40,[4] it would not apply the new lessor accounting requirements to the lease; that is, the lessor would continue to account for those leases as operating leases, as specified in IAS 17.[5]

Because U.S. GAAP do not currently require entities, or provide an option, to measure investment properties at fair value through earnings, the FASB recently added a project on investment properties to its agenda. The primary objective of this project is to decide whether reporting entities should be permitted (or required) to measure investment properties at fair value through earnings on a recurring basis. This project also will contemplate how an entity should consider a lease when measuring the fair value of a leased investment property.

[4] IAS 40, *Investment Property*.

[5] IAS 17, *Leases*.

One VRG member emphasized that the Board should consider aligning the guidance on initial measurement in a business combination with that on the subsequent measurement of an investment property that is measured at fair value through earnings.

In U.S. GAAP, there is no specific guidance on how an entity should determine the unit of account when estimating the fair value of a leased asset outside of a business combination, though some highlight that ASC 820 requires entities to consider attributes of an asset when estimating fair value and believe that a lease is an attribute of a leased property. Some believe that an entity would consider an in-place lease in determining the fair value of a leased asset for impairment testing.

Question 1: The FASB staff requested VRG members' perspectives on common practices and techniques for estimating the fair value of leased investment properties (including above- or below-market leases) and on whether an above- or below-market lease is separately analyzed or estimated.

Discussion: VRG members indicated that in a business combination, practice is to value the property separately from any above- or below-market lease (i.e., to attribute value to each property). One VRG member expressed his belief that the accounting literature on acquisitions of real estate that are not addressed by ASC 805 (formerly Statement 141(R)[6]) needs to be clearer.

Question 2: The FASB staff also asked VRG members for their views on how a reporting entity should consider an above- or below-market lease if the investment property is measured at fair value through earnings.

Discussion: The majority of VRG members agreed that the fair value measurement of the leased asset should take into account any off-market leases. One VRG member emphasized that the Board should consider aligning the guidance on initial measurement in a business combination with that on the subsequent measurement of an investment property that is measured at fair value through earnings (i.e., both should be presented as a single unit of account).

VRG Issue No. 2010-03: Measurement of Reacquired Rights in a Business Combination

Background: In a business combination, an acquirer may acquire a right that it previously had granted to an acquiree (the "reacquired right"). One example of such a right is a right to use the acquirer's trade name under a franchise agreement. Under ASC 805, a reporting entity is required to:[7]

- Recognize a reacquired right as an identifiable intangible asset that is separate from goodwill.
- Recognize a settlement gain or loss to the extent that the terms of the contract are favorable or unfavorable, respectively, compared with market terms.

ASC 805 states that an acquirer must measure the value of a reacquired right on the basis of the remaining contractual terms of the related contract, regardless of whether market participants would consider potential renewals in determining fair value. Therefore, the measurement guidance in ASC 805 on reacquired rights represents an exception to the general measurement principle (i.e., fair value) that applies to assets and liabilities acquired in a business combination.

Question 1: The FASB staff asked VRG members for their views on how a reporting entity should measure the value of a reacquired right.

Discussion: Some VRG members thought that the reacquired right should be measured on the basis of a valuation technique that considers the acquiree's cash flows after payment of an at-market royalty rate to the acquirer. Some examples of appropriate valuation techniques may include a multiperiod excess earnings method, "with and without" method, or greenfield method. Some VRG members noted that there is diversity in practice in dealing with restrictions that are inherent in change-of-control provisions.

[6] FASB Statement No. 141(R), *Business Combinations*.

[7] This requirement was originally outlined in EITF Issue No. 04-1, "Accounting for Preexisting Relationships Between the Parties to a Business Combination."

Question 2: The FASB staff requested VRG members' views on scenarios in which a third party acquires an entity that had a franchise right that was not reacquired and on whether, under ASC 805, the acquirer would recognize the franchise right as an intangible asset that is separable from goodwill.

Discussion: Two VRG members expressed their view that an entity would recognize an intangible asset separately from goodwill in this scenario.

VRG Issue No. 2010-04: Fair Value Measurement of Accounts Receivable, Accounts Payable, and Other Accrued Liabilities

Background: The VRG previously discussed (Issue 2008-16) the following two approaches to measuring the fair value of accounts receivable (AR) acquired, accounts payable (AP), and accrued liabilities assumed in a business combination pursuant to ASC 805 and ASC 820:

- The fair value of AR will generally be based on the sale of AR to a market participant engaged in the business of acquiring AR.
- The market participant is a potential acquirer of the business as a whole and will need the acquired net working capital to continue as an ongoing business. The fair value measurement assumes that the highest and best use of the AR acquired is in-use within a reporting entity's ongoing business operations.

Question: The FASB staff asked for VRG members' perspectives on the appropriate approach for measuring the fair value of AR, AP, and other accrued liabilities.

Discussion: Most VRG members indicated that the second approach above would be most appropriate. Those members believed that the assumption for these items is that the highest and best use is in-use. Many members did not believe that the exit price notion required entities to value receivables at an amount they would receive to sell the receivables to a market participant that engaged in the business of acquiring receivables. In their discussion of other accrued liabilities, they noted that an entity would need to evaluate nonperformance and liquidity risk related to warranty accruals. Some VRG members remarked that the Board's tentative conclusions about eliminating the in-use valuation premise for financial instruments could cause other issues in the valuing of these types of assets and liabilities.

Some VRG members noted that the fair value of AR, AP, and other accrued liabilities for accounting purposes often does not align with the economic decisions that are involved in these transactions. Buyers and sellers may, for example, agree to the amount of working capital that will come with a business, and due diligence is conducted regarding the likelihood of collecting AR, but a valuation analysis of working capital items is typically not performed. Unique situations may exist in certain industries (e.g., at financial institutions, credit card receivables are a significant aspect of the business operations).

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