

Heads Up

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Valuation Resource Group Discusses Four Topics at November 1 Meeting

by Tiffany Prudhomme and Adrian Mills, 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. Tiffany Prudhomme and Adrian Mills observed the meeting. The notes below represent the authors' interpretations of the discussions held at the November 1, 2010, VRG meeting. The views expressed are not necessarily the views of the authors or of Deloitte. For technical interpretations of ASC 820¹ 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. 2010-05: Fair Value Measurement of Contingent Consideration in a Business Combination

Background: ASC 805 requires that contingent consideration be recognized and measured at fair value as of the acquisition date as part of the consideration transferred in exchange for the acquired business. Questions have arisen about how to apply the concepts of ASC 820 to the valuation of contingent consideration. Specifically, some question whether a liability must be traded in a market as an asset (i.e., as a Level 1 or Level 2 input) for a reporting entity to measure the fair value of a liability on the basis of the fair value of the corresponding asset (i.e., an asset valuation premise).

The following example and two alternative views were discussed:

Example

Assume that a buyer agrees to acquire 100 percent of a target. As part of the consideration paid, the buyer pays contingent consideration to the target's shareholders on the basis of the target's future revenue. In this case, the contingent consideration is an asset to the former shareholders of the target and a liability to the buyer.

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

View A — For an asset valuation premise to be used in the fair value measurement of a contingent consideration liability, the fair value of the contingent consideration asset must be observable (i.e., estimated by using Level 1 inputs, Level 2 inputs, or both).

Proponents of View A believe that when there is no observable market for a contingent consideration asset (which is often the case), it is not appropriate to assume that the buyer could repurchase the contingent consideration asset in the market and thereby settle the contingent consideration liability.

View B — An asset valuation premise can be used to measure the fair value of a contingent consideration liability, regardless of the inputs used to measure the fair value of the contingent consideration asset.

Proponents of View B believe that, in accordance with the definition of fair value in ASC 820, a fair value measurement must take into account a transaction between market participants on the measurement date. Thus, in the absence of a real market, a hypothetical market is assumed. Reporting entities should also assume that this market is efficient and competitive. In View B, the market would capture any arbitrage opportunity and the fair value of the contingent consideration as a liability would approximate the fair value as an asset.

Question: The VRG was asked what valuation premise is appropriate for an entity to use when measuring the fair value of contingent consideration.

Discussion: VRG members generally supported an approach similar to View B. Concerns were expressed about View A, including the potential for (1) different discount rates for assets and liabilities even though the cash flows are the same and (2) “day 2” goodwill impairments. VRG members recommended that the Board amend ASC 820 to clarify that it is acceptable, at all levels of the hierarchy, to use an asset valuation method when measuring the fair value of a contingent consideration liability.

VRG Issue No. 2010-06: Application of the Multiperiod Excess Earnings Method and the Greenfield Method to Intangible Assets

Background: In 2004, the EITF issued Topic D-108² (codified in ASC 805-20-S99-3). ASC 805-20-S99-3 states, in part:

[T]he SEC staff believes the **residual method should no longer be used to value intangible assets other than goodwill**. Rather, a direct value method should be used to determine the fair value of all intangible assets required to be recognized at fair value under Topic 805. [Emphasis added]

Topic D-108 was issued in response to practices in which some preparers used a residual method to estimate the fair value of certain intangible assets, which resulted in no goodwill. Some have questioned whether the multiperiod excess earnings method (MPEEM) is a “residual method,” as contemplated in Topic D-108. In general terms, an entity uses the MPEEM to measure the fair value of an intangible asset by estimating the related asset group’s expected free cash flows and then subtracting a charge for the use of the other identified tangible and intangible assets. These excess earnings are assumed to be attributable to the subject asset being measured at fair value. The fair value of the intangible asset is the present value of these expected cash flows after an entity considers the tax benefit that may arise from the amortization of the asset.

Some entities have used the Greenfield method as an alternative to the MPEEM to estimate the fair value of certain intangible assets. The Greenfield method assumes that the only asset owned by the entity on the valuation date is the individual intangible asset. Future cash inflows and outflows are estimated as a viable business is created around the subject intangible asset. Any cash flows associated with tangible or intangible assets, including goodwill, are assumed to be “paid for” in the start-up costs of the new business that are captured in the discounted cash flow analysis. Some believe that this approach satisfies the “direct value method” called for by ASC 805-20-S99-3.

Question: The VRG was asked whether the MPEEM is a residual method, as contemplated in Topic D-108.

² EITF Topic No. D-108, “Use of the Residual Method to Value Acquired Assets Other Than Goodwill.”

Discussion: VRG members indicated that if it is properly applied, the MPEEM is a direct value method, not a residual method as contemplated in Topic D-108. The SEC staff observer agreed with the VRG on this point; thus, the MPEEM is not prohibited by Topic D-108. VRG members did not believe that prescriptive guidance is needed on when to use the MPEEM or the Greenfield method or on how the methods should be applied. They also highlighted that incorporating a “going-concern contributory charge” is challenging because this term is not well defined. An assembled workforce was cited as an example of a going-concern charge. Some VRG members suggested that valuation practitioners consider the guidance in the Appraisal Foundation’s working group report, “The Identification of Contributory Assets and Calculation of Economic Rents.”

VRG Issue No. 2010-07: Proposed Accounting Standards Update, *How the Carrying Amount of a Reporting Unit Should Be Calculated When Performing Step 1 of the Goodwill Impairment Test*

Background: On October 6, 2010, the FASB issued a proposed ASU, *How the Carrying Amount of a Reporting Unit Should Be Calculated When Performing Step 1 of the Goodwill Impairment Test*. The proposed ASU requires that (1) an entity use an equity premise to calculate the carrying amount of a reporting unit when performing step 1 of the goodwill impairment test and (2) if a reporting unit has a zero or negative carrying amount, the entity must assess, on the basis of qualitative factors such as those listed in ASC 350-20-35-30 (these factors are not all-inclusive), whether it is more likely than not that a goodwill impairment exists (i.e., if it is more likely than not that a goodwill impairment exists, step 2 must be performed).

Question: The VRG was asked whether (1) any unintended consequences would result from performing step 1 of the goodwill impairment test by calculating the carrying amount as the difference between total assets and total liabilities assigned to the reporting unit in accordance with ASC 350-20-35-39 or (2) there are any other concerns about the proposed ASU.

Discussion: Some VRG members questioned whether the Board intended to change how step 2 of the goodwill impairment test is performed. The VRG recommended clarifying that the proposed ASU only addresses step 1 of the goodwill impairment test (specifically, how to assess situations in which an entity has a zero or negative carrying value).

Some VRG members also questioned whether the qualitative factors in ASC 350-20-35-30 were too subjective for an entity to effectively assess whether the goodwill of a reporting unit with a zero or negative carrying amount is more likely than not impaired. Because of the subjectivity, some believed that auditors are likely to err on the side of caution and require entities to perform step 2 of the goodwill impairment test in the year of adoption of the new guidance and perhaps in later periods. However, some VRG members suggested that the results of a step 2 test in the year of adoption would serve as a good baseline for making decisions in future years when there is a zero or negative carrying value.

VRG Issue No. 2010-08: Measurement Uncertainty Analysis Disclosure and Possible Alternatives

Background: On June 29, 2010, the FASB and IASB issued exposure drafts (EDs) that would both require entities to disclose information about measurement uncertainty in the form of a sensitivity analysis for recurring fair value measurements categorized in Level 3 of the fair value hierarchy unless another Codification topic specifies that such disclosure is not required (e.g., investments in unquoted equity instruments are not within the scope of the disclosure requirement of the FASB’s ED on accounting for financial instruments). Specifically, the amendment to ASC 820-10-50-2(f) states that an entity would disclose the following:

A measurement uncertainty analysis for fair value measurements categorized within Level 3 of the fair value hierarchy. If changing one or more of the unobservable inputs used in a fair value measurement to a different amount that could have reasonably been used in the circumstances **would have resulted in a significantly higher or lower fair value**

measurement, a reporting entity shall disclose the effect of using those different amounts and how it calculated that effect. When preparing a measurement uncertainty analysis, a reporting entity shall not take into account unobservable inputs that are associated with remote scenarios. A reporting entity shall **take into account the effect of correlation between unobservable inputs** if that correlation is relevant when estimating the effect on the fair value measurement of using those different amounts. For that purpose, significance shall be judged with respect to earnings (or changes in net assets) and total assets or total liabilities, or, when changes in fair value are recognized in other comprehensive income, with respect to total equity. [Emphasis added]

The ED comment letter period ended on September 7, 2010. The boards maintain the objective of issuing final common fair value measurement and disclosure requirements under U.S. GAAP and IFRSs in early 2011.

Editor’s Note: For more information about the FASB’s and IASB’s EDs on measurement uncertainty analysis disclosures, see Deloitte’s [June 30, 2010, Heads Up](#).

The FASB staff indicated that comment letters did not support the measurement uncertainty proposal. The FASB staff asked VRG members for feedback on the following three options (from the VRG meeting materials) as alternatives to the proposal included in the EDs:

Option 1 Proceed with the proposed measurement uncertainty analysis disclosure, with clarifications	Option 2 Proceed with a disclosure of qualitative information about Level 3 fair value measurements	Option 3 Proceed with a sensitivity analysis about fair value measurements, excluding the effect of inter-relationships between inputs
<p>Revise the disclosure to address the practical concerns raised by preparers and auditors:</p> <ul style="list-style-type: none"> clarify the objective of the disclosure; remove the term ‘correlation’ to avoid confusion (use ‘interrelationships’ instead); emphasize that the threshold for performing the analysis can be met only when there are other assumptions that would have been reasonable and using those other assumptions would have a significant effect on the measurement; and emphasize the need for supporting qualitative information to help users to better understand the analysis. <p>Revise the example to show how the measurement uncertainty analysis could be performed, in addition to how it could be presented. The example could show:</p> <ul style="list-style-type: none"> how to assess which other inputs could have reasonably been used in the circumstances and their effect on the analysis; and how to determine interrelationships between inputs and their effect on the analysis. 	<p>Require additional qualitative disclosure about the inputs and valuation techniques used in Level 3 fair value measurements, including a qualitative discussion of:</p> <ul style="list-style-type: none"> the sensitivity to the key inputs; information about interrelationships between inputs; and the controls and processes used by the reporting entity in estimating fair value. <p>As part of the qualitative disclosure, require quantitative information about the significant unobservable inputs used in the analysis.</p>	<ul style="list-style-type: none"> Require a sensitivity analysis disclosure similar to that in IFRS 7 and in the IASB’s May 2009 exposure draft (i.e., excluding the effect of inter-relationships between inputs) for Level 3 fair value measurements. Reword to be consistent with current proposal with respect to using ‘inputs that were reasonably possible in the circumstances’ rather than ‘reasonably possible alternative inputs.’ Clarify the objective of the disclosure and provide further guidance on its requirements so as to increase comparability (IFRS 7 currently does not have an example of how the disclosure should be prepared or presented). An alternative to Option 3 would be to modify the sensitivity analysis to specify a predetermined change in key inputs (e.g., a +/- X% change in an input).

Question: The VRG was asked which option it supports.

Discussion: Most VRG members supported a disclosure requirement similar to option 2. However, some had reservations about whether option 2 should include a requirement to provide quantitative information. The reservations relate to the fact that such disclosures would most likely need to be aggregated by class or other aggregation level. These VRG members believe that any amount of aggregation yields information that is not meaningful and that providing quantitative information for every asset or liability separately would be overwhelming to financial statement users. Concerns were also expressed about the difficulty of obtaining quantitative information from third parties.

VRG members believe that if the FASB goes forward with some form of measurement uncertainty analysis (option 1 or 3), the unquoted equity scope exception should remain in place. They further believe that investments that are measured at fair value by using net asset value as a practical expedient are unquoted equities and should be exempt (thus, the ED should be revised to exclude those investments from the sample measurement uncertainty table).

Additional VRG Issue Added to Agenda³ — Consideration of Proposed Amendments to Guidance on Blockage Factors

Background: The FASB's June 29, 2010, ED on fair value measurements (as highlighted above under Issue 2010-08) includes a proposal to amend the fair value measurement guidance on the use of blockage factors. The proposal clarifies that the application of a blockage factor is prohibited at all levels of the fair value hierarchy and notes that a "blockage factor is not relevant and, therefore, shall not be used when fair value is measured using a valuation technique that does not use a quoted price for the asset or liability (or similar assets or liabilities)." The Board indicated that the prohibition on using blockage factors is necessary because blockage is "specific to that reporting entity, not to the asset or liability."

Question: VRG members were asked whether they agree with the proposal to eliminate the use of blockage factors at all levels of the fair value hierarchy, particularly Levels 2 and 3.

Discussion: VRG members indicated that the proposed definition of blockage was unclear and that it would therefore be difficult for entities to apply when there are no quoted prices in active markets for the same asset or liability being measured at fair value (i.e., when the measurement is Level 2 or Level 3). They encouraged the Board to consider whether there is a principle that could replace the blockage "rule." For example, the Board could eliminate the term "blockage" and replace it with a valuation maximization principle. The VRG also noted that the blockage prohibition may not reflect how transactions actually occur in the market. Some VRG members suggested that the Board further study what the unit of account should be before expanding the blockage prohibition.

³ The FASB staff added this item to the agenda during the VRG meeting.

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