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Valuation Resource Group Discusses Six Topics at February 1, 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, and valuation experts. VRG meetings are coordinated by the FASB staff and observed by the SEC, the AICPA, and the PCAOB. The VRG does not make any 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 observes the meetings. The notes below represent the authors' interpretations of the discussions held at the February 1, 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](#).

Meeting Discussion Notes

[VRG Issue 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: This concept, termed "defensive value," was previously discussed at the October 1, 2007, meeting. At that 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 various topics related to 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 phase out over a one-year period and then retire but deny other market participants access to for defensive reasons.

Question 1: Who are the market participants?

Discussion: The VRG commented that one of the key aspects to valuing a defensive value asset is to determine the characteristics that make up a market participant. In its discussion of determining the fair value of an acquired trademark, the VRG noted that market participants could include the following:

- A financial buyer that would continue to fully use the trademark in its operations.
- A strategic buyer that would continue to fully use the trademark in its operations because it has no competing brand or a weaker brand.
- A strategic buyer that would retire the trademark for defensive reasons because it has a stronger brand.
- A strategic buyer that would abandon the trademark.

Fair value measurements assume the highest and best use of the asset by a market participant. In a business combination in which the unit of valuation is often a group of assets, the market participant is selected according to whether it provides the highest and best use of the group of assets, not necessarily the highest and best use of the individual assets within the group. Some VRG members indicated that this concept is expressed in Example 1 in Appendix A of Statement 157. In that example, the selected market participant did not maximize the fair value of each of the individual assets but rather maximized the fair value for the group of assets. The VRG also indicated that the fair value of the acquired trademark might differ according to the intended use of the market participant. See discussion in question 2 below.

Question 2: How should the asset be valued?

Discussion: The VRG agreed that in the valuation of a defensive value asset, the valuation method would generally depend on the intended use of the trademark by the market participant. Some members offered that a “with-versus-without” model might be appropriate for calculating the fair value of a trademark being retired for defensive purposes. That is, the defensive value is the incremental cash flows achieved by the existing trademark because of the locking up of the acquired trademark. Fair value would be calculated as the difference in fair value of the existing trademark had both trademarks been in the market and the fair value of the trademark with only the existing trademark in the market. Some offered that the fair value of the trademark that was going to be used by a market participant could be calculated by using a “relief-from-royalty” method. That method holds that without ownership of the trademark, the user would have to make a stream of payments to the owner of the trademark in return for the rights to use the trademark. Lastly, if the market participant would abandon the trademark, it may have little or no fair value. Abandoning would be the equivalent of giving the trademark away.

Question 3: What is the useful life of the asset?

Discussion: The VRG discussed a variety of alternatives for useful life, ranging from immediate impairment of the asset to indefinite life. Most participants agreed that an immediate impairment of the newly acquired trademark was generally not appropriate. For acquired assets that provide additional value to existing indefinite-lived assets, such as a trademark, some members indicated that they believe that value may sometimes be permanent. These members believe that if permanent value increase is concluded, the asset should also be given an indefinite life. Other members noted that they have a hard time believing that the value of a trademark that is neither used in operations nor supported by marketing and advertising can last indefinitely. Those members argued that when one no longer has to defend the asset, the fair value of the asset is not significant. They believe that this would indicate a finite life and that the asset should be amortized over that period.

Question 4: How should the asset be tested for impairment?

Discussion: The views on this topic were generally consistent with those on the useful life of the asset. Those who believe that the defensive value asset permanently increased the value of existing assets indicated that the impairment analysis would include the direct and indirect cash flows of the combined assets. Some noted that current GAAP may not allow existing assets to be combined with newly acquired assets. They would refer to EITF Issue No. 02-7, "Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets," which discusses combining assets for amortization and impairment analysis. Those who believe that the asset should have a finite life indicated that the impairment analysis would follow FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Under Statement 144, the asset would be tested for recoverability when events or changes in circumstances indicate that the carrying amount may not be recoverable.

The FASB staff asked the VRG whether additional guidance is necessary for the subsequent accounting for defensive value assets. The VRG indicated that there will be differing views on useful life and impairment, which may lead to diversity in practice. Some members indicated that additional guidance on subsequent accounting would be useful.

VRG Issue No. 2008-2: Customer Relationships

Question: Should overlapping customer relationships acquired in a business combination be recognized as an intangible asset apart from goodwill?

Discussion: The FASB staff indicated that this question did not result from the issuance of Statement 157; however, the staff wanted to understand whether there was currently diversity in practice. The VRG indicated that the diversity in practice has decreased as a result of a December 2005 speech by an SEC staff member, Pamela Schlosser. She stated that the SEC found it difficult to accept no value being given to a customer relationship intangible asset for overlapping customers. The VRG expressed concern that because of that speech, too much value may currently be placed on customer relationship intangibles for overlapping customers. This is partly because the multi-period excess earnings method, which is the method generally used for valuing customer relationships, often does not lend itself to representing the economics of the transaction. The principle behind the multi-period excess earnings method is that the value of an intangible asset is equal to the present value of the incremental after-tax cash flows attributable only to the subject intangible asset. It is difficult to identify incremental cash flows for overlapping customers resulting from an acquisition. Some members indicated that intangible assets associated with overlapping customers may not have significant value in some circumstances. However, under current accounting, intangible assets for overlapping customers are assigned a value similar to that of incremental customers, all else being equal. Members indicated that guidance on exactly what companies are trying to capture in overlapping customer relationships would be helpful.

VRG Issue No. 2008-3: Valuation of Intangible Assets Using the "Current Replacement Cost" Method

Question: Is the current replacement cost method calculated on a pretax or an after-tax basis?

Discussion: Some members indicated that certain practitioners are confused 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. This calculation should be pretax because capital investments are recorded gross of tax.

Some practitioners inappropriately 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.

While members did not agree about the extent of the diversity in practice, they did agree that inappropriately tax-affecting the cost approach would create a significant difference in the calculation, particularly when a preliminary indication of value that is reduced by the tax effect does not subsequently incorporate the tax amortization benefit.

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

Question: Does the term “legally permissible,” as used in paragraph 12 of Statement 157, mean permissible as of the measurement date, or can it be more broadly interpreted to mean permissible in the future?

Discussion: The VRG was given an example in which an entity holds a piece of land that is zoned for residential use as of the measurement date; however, the highest and best use of the land is to rezone it to commercial use. The VRG indicated that a broad view would generally be appropriate but that the risks of rezoning and cost to transform the asset would have to be considered in the measurement. Therefore, the fair value would not be the residential value or the commercial value but somewhere in between.

Some members indicated that if the markets were working efficiently, the value would be the same. For example, if the risks of obtaining the commercial zoning rights were high, market participants would value the land closely to the residential market value. However, if the risks of rezoning the property were low, market participants would value the property more closely to the commercial market value.

VRG Issue No. 2008-5: Fair Value of Inventory

Question: When finished goods inventory is acquired in a business combination under FASB Statement No. 141(R), *Business Combinations*, the acquired inventory should be measured at fair value under Statement 157. When considering Statement 157’s exit price notion and highest-and-best-use concept, how should one determine the fair value of finished goods inventory?

Discussion: The example provided was a pair of socks with a retail value of \$12 and a net realizable value (NRV) of \$10. The VRG indicated that the fair value should be close to the NRV, which allows the acquirer to realize a profit on the selling effort. The VRG indicated that this is supported by paragraph A24(f) of Statement 157, which provides the following guidance on valuing finished goods inventory at a retail outlet:

[T]he fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement should be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward).

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

Background: Statement 157 indicates that the fair value of an asset or liability is determined on the basis of assumptions used by market participants in pricing an asset or liability. Because market participants would consider counterparty credit risk in pricing a derivative contract, 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. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires that hedge effectiveness be assessed for each hedging relationship not at the portfolio level. In addition, Statement 133 Implementation Issue No. G10, "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.

In introducing the topic, the FASB staff asked the VRG not to consider whether the portfolio-based credit adjustment on a portfolio of derivatives is required to be allocated to individual derivatives in a portfolio for consideration in hedge effectiveness testing. The FASB staff indicated that this question was not a fair value issue but rather a Statement 133 issue. The staff acknowledged that this was another area in which differences in the unit of valuation and the unit of account creates complexity.

Question: How should portfolio-based credit adjustments on a portfolio of derivatives be allocated to individual derivatives in the portfolio?

Discussion: The FASB staff initiated the discussion by providing four potential methods to use in allocating the portfolio-based credit adjustment to individual derivatives. Some members on the VRG suggested that there is no rational method to use for the allocation that would appropriately reflect the economics of the individual derivative contract. The VRG did not discuss in detail the pros and cons of each method provided by the FASB staff, but expressed its view that if an allocation is required under GAAP, guidance that provides a systematic method that is easy to apply would be preferable. Some members indicated that the adjustment is generally not material and that the allocation may not be necessary.

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