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### MINUTES OF THE VALUATION RESOURCE GROUP MEETING September 23, 2008

#### Overview and Background

The Financial Accounting Standards Board (FASB) formed the Valuation Resource Group (VRG) in the summer of 2007 to provide the FASB with input on potential clarifying guidance regarding issues relating to the application of the principles of FASB Statement No. 157, *Fair Value Measurements*. The VRG does not issue guidance or interpret Statement 157. For a further discussion of the VRG, its operating procedures and current membership refer to the following website:

[http://www.fasb.org/project/valuation\\_resource\\_group.shtml](http://www.fasb.org/project/valuation_resource_group.shtml)

These minutes of the VRG's meeting on September 23, 2008, were prepared by Amy A. Ripepi, Managing Director – Financial Reporting Advisors, LLC. Ms. Ripepi is a member of the VRG and also serves on the Editorial Advisory Board of Accounting Research Manager<sup>®</sup>. This unofficial summary represents only one account of the discussion at the meeting. The purpose of this summary is to provide an overview of the topics discussed, not to provide guidance or conclusions. None of the members of the FASB or its staff have reviewed this summary. Any changes to or clarifications of Statement 157 would be published by the FASB. Official positions of the FASB on accounting matters are determined only after extensive due process and deliberation.

VRG discussions do not result in authoritative decisions or provide implementation guidance. Further, because the discussions are intended to solicit information about issues that have the potential for significant diversity in practice and identify alternative points of view, some of the observations and ideas offered at the meeting and documented in these unofficial minutes may not be consistent with the principles of Statement 157.

Through September 23, 2008, the VRG has held five meetings. The Appendix to these minutes lists the issues discussed by the VRG since its inception. Minutes of other meetings are available on Accounting Research Manager<sup>®</sup>.

The topics discussed at the September 23, 2008 meeting were:

- Issue No. 2008-11: IASB Expert Advisory Panel White Paper
- Issue No. 2008-12: Fair Value Disclosures
- Issue No. 2008-13: Observable vs. Unobservable Inputs
- Issue No. 2008-14: Fair Value Measurement of Liabilities under FAS 157
- Issue No. 2008-15: Allocation of In-Use Valuation to Individual Unit of Account
- Issue No. 2008-16: Fair Value of Accounts Receivable, Accounts Payable and Other Accrued Liabilities
- Issue No. 2008-17: Identification and Allocation of Market Participant Synergies
- Issue No. 2008-18: Fair Value of a Noncontrolling Interest and a Previously Held Equity Interest

## **VRG Issue No. 2008-11: IASB Expert Advisory Panel White Paper**

### ***Summary***

The VRG was asked to consider the usefulness and relevance of a draft white paper entitled “Measuring and Disclosing the Fair Value of Financial Instruments in Markets that are No Longer Active.” The paper is the product of recent discussions by an expert advisory panel of the International Accounting Standards Board (IASB).

### ***Issue***

Under existing International Financial Reporting Standards (IFRS), certain financial instruments are reported at fair value. Although the IFRS definition of fair value is not identical to the definition in Statement 157, there are many similarities. For example, under International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, the fair value of a financial instrument is based on quoted prices in an active market; however, when no active market exists, fair value is based on a valuation technique that “incorporates all factors that market participants would consider in setting a price.” IAS 39 also notes that values received or paid in a forced transaction, involuntary liquidation or distressed sale are not indicative of fair value. Thus, companies that prepare their financial statements under IFRS are faced with valuation issues for financial instruments that are substantially the same as those currently faced by companies following U.S. generally accepted accounting principles (GAAP).

The IASB formed an Expert Advisory Panel in May 2008. Its purpose was to help the IASB determine the need for guidance on valuation methods and disclosures for financial instruments when markets are inactive. The Panel published a draft paper dated September 16, 2008 entitled, “Measuring and Disclosing the Fair Value of Financial Instruments in Markets that are No Longer Active,” that includes observations on various valuation and disclosure considerations. A copy of the draft paper is available on the IASB’s website. [http://www.iasb.org/NR/rdonlyres/F309C029-84B4-4F1F-BFB6-886EE9922A42/0/Expert\\_Advisory\\_Panel\\_draft\\_160908.pdf](http://www.iasb.org/NR/rdonlyres/F309C029-84B4-4F1F-BFB6-886EE9922A42/0/Expert_Advisory_Panel_draft_160908.pdf)

After receiving and considering comments on the draft, the IASB is expected to publish the final paper as an educational resource. It would not represent official interpretations of, or implementation guidance on, IAS 39.

VRG members were asked whether the observations in the Panel’s draft paper (a) are in conflict with the requirements of Statement 157, (b) are inconsistent with their experiences, and (c) would be useful in the United States.

### ***Discussion***

VRG members believed the draft paper was well organized and contained useful information that would be helpful in the United States to preparers, valuation specialists, auditors and investors. Although no one identified any content that appeared inconsistent with the requirements of Statement 157, some VRG members noted that certain aspects of the draft paper appeared somewhat prescriptive and suggested using language that is less absolute.

Two aspects of the draft paper were discussed in some detail:

1. The draft paper addresses adjustments to valuation models for liquidity, credit risk and other factors. Some observed that the narrative seems to incorrectly imply that valuation models generally fail to incorporate liquidity and credit risk such that additional adjustments typically are needed to arrive at fair value. In fact, many models take these factors into account. Thus in many cases there is no need to make an incremental adjustment to the output of the model. Others observed that the narrative might be read as permitting, rather than requiring,

consideration of factors such as liquidity and credit risk. Members of the VRG commented that in their view, the inclusion of these factors is not optional when estimating the fair value of a financial instrument.

2. The draft paper addresses the use of fundamental analysis to determine fair value when market prices are unusually depressed. It states that “fundamental values are not consistent with the objective of a fair value measurement.” Fundamental analysis (or fundamental value) determines an instrument’s value based principally on an estimate of future cash flows over the life of the instrument. As a result, if there has been no decline in cash flow estimates over the life of the instrument, fundamental analysis would indicate that there is no decline in the instrument’s value. Proponents of fundamental value argue that when market conditions are at an extreme (e.g., an abnormally inactive market exhibiting panic or an hyperactive market exhibiting hysteria), there is an illogical view of risk that should be tempered by focusing on the instrument’s underlying cash flows in the normal course. Some members of the VRG expressed support for fundamental analysis as a basis for understanding the economic value of an instrument. However, it was generally agreed that, as stated in the draft paper, the objective of fundamental analysis is not consistent with the objective of a fair value measurement. By ignoring existing factors that market participants would consider when pricing an instrument, the value resulting from a fundamental analysis would not represent an estimate of a current transaction price and thus would not represent fair value. In particular, it was noted that the requirement to consider current market conditions, however illogical those conditions might seem, results in more consistency in the inputs to valuation models across companies.

Other VRG discussions related to valuation issues in an inactive market include VRG Issue No. 2008-07 discussed in May 2008 and VRG Issue No. 2008-13 discussed at this meeting (see below).

## **VRG Issue No. 2008-12: Fair Value Disclosures**

### ***Summary***

The VRG was asked for its observations regarding the need for incremental financial statement disclosures related to fair value measures.

### ***Issue***

Statement 157 requires disclosure of information that is intended to assist users of financial statements assess the inputs used to develop fair value measurements (paragraphs 32-37). The nature of the information to be disclosed varies somewhat between assets and liabilities that are measured at fair value on a recurring basis (such as derivatives and other financial instruments that are recorded at fair value) and assets and liabilities that are measured at fair value on a nonrecurring basis (such as property and equipment and other long-lived assets that, if impaired, are written down to fair value).

The FASB staff has received requests to expand the current disclosure requirements in Statement 157, particularly for fair value measures of financial instruments. The specific disclosure requests can be summarized as follows:

1. More information regarding the valuation techniques, inputs and assumptions used value to financial assets and liabilities that are in Levels 2 and 3 (i.e., the assets and liabilities that are being measured using some degree of subjectivity).
2. More information about the effects of an entity’s own credit on the determination of fair value.

3. More information about the sensitivity of fair value estimates to significant inputs.
4. More disaggregated information regarding various existing elements of the disclosures (more disaggregation of assets and liabilities, segregating transfers in and out of categories, less netting of gains and losses, etc.).
5. More qualitative information about underlying collateral, credit enhancements, and guarantees related to financial assets and liabilities.

The VRG was asked to comment on the various suggestions the FASB staff has received vis -a-vis additional financial statement disclosures related to fair value measures.

### ***Discussion***

The IASB Expert Panel paper discussed earlier (see VRG Issue No. 2008-11) addresses many of the same disclosure considerations. VRG members acknowledged that in a time of extreme uncertainty, there is a natural desire for more information. The challenge is to provide relevant information that is useful without going into unnecessary detail or inadvertently obscuring important information. In particular, the IASB Expert Panel draft paper notes that “it is not the purpose of the disclosure to allow recalculation of fair values.”

It was also noted that although the Securities and Exchange Commission (SEC) staff has encouraged public companies to voluntarily provide more granularity or additional analysis, relatively few have done so. Some have expressed concern that providing supplemental information could lead to subsequent criticisms of ‘cherry-picking,’ that is, second-guessing management’s framework for determining which additional information to voluntarily disclose and which to omit.

Of the numerous possible additional disclosures identified, there were three in which VRG members expressed particular interest:

1. More information about the effect of an entity’s own credit in determining the fair value of a liability. In particular, it was suggested that the disclosures required by FASB Statement No. 159, *The Fair Value Option for Financial Assets and Liabilities*, be required for other liabilities (including derivatives) that are measured at fair value. Statement 159 requires the following information when the fair value of a liability has been significantly affected by changes in the instrument-specific credit risk:
  - a. Estimated amount of gains and losses from fair value changes included in earnings that are attributable to changes in the instrument-specific credit risk;
  - b. Qualitative information about the reasons for those changes; and
  - c. How the gains and losses attributable to changes in instrument-specific credit risk were determined.
2. More information about the sensitivity of fair value estimates to significant inputs. In particular, it was suggested that a company might disclose the range of values that would result from changes in significant inputs or assumptions. The group did not discuss specifics, for example, how significant inputs would be identified or how extensive the change in the input should be for purposes of providing a reasonable or realistic range. Some VRG members commented on the high degree of judgment and subjectivity needed to determine (a) whether or how to aggregate instruments, (b) which inputs were most significant, and (c) the extent to which inputs should be varied for purposes of a sensitivity analysis. For that reason, without a clear framework explaining the objectives of a sensitivity analysis, the resulting information might not be useful or comparable. [Author’s Note: If a public company considers the valuation

of financial instruments to be a critical accounting estimate, certain disclosures are required in Management's Discussion and Analysis of Financial Condition and Results of Operations. Refer to the SEC's *Cautionary Advice Regarding Disclosure about Critical Accounting Policies* as well as Section V. of Financial Reporting Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations.*]

3. More information about transfers of assets and liabilities between levels in the fair value measurement hierarchy. For example, the SEC staff has suggested that public companies disclose the amount and reasons for any material increase or decrease in Level 3 assets and liabilities resulting from an entity's transfer of assets and liabilities from, or into, Level 1 or Level 2, including the significant inputs that the company no longer considers to be observable. [Author's Note: The SEC staff has written two letters recommending that public companies provide additional information related to fair value measures. Both letters are available on the SEC's website. The first letter was dated March 27, 2008 and the second letter was dated September 16, 2008.]

### **VRG Issue No. 2008-13: Observable vs. Unobservable Inputs**

#### ***Summary***

The VRG was asked how practice is dealing with observable market information during the current credit crisis, that is, in markets where trading activity is infrequent and may be at significantly discounted prices.

#### ***Issue***

Statement 157 establishes a three-tiered hierarchy to prioritize the inputs used to measure fair value (paragraphs 22-31). Within Level 1 and Level 2 of the hierarchy, all significant inputs are developed based on market data obtained from sources independent of the reporting entity (referred to as "observable inputs"). Within Level 3 of the hierarchy, one or more significant inputs reflect the reporting entity's own assumptions about how market participants would price the asset or liability (referred to as "unobservable inputs"). The three levels therefore distinguish the relative reliability of inputs to a fair value measurement. Level 1 inputs, which are based on the trading of identical instruments in active markets, are the most reliable and objective. Level 2 inputs, which are based on similar instruments in active or inactive markets or identical instruments in inactive markets, are less reliable than Level 1 but more reliable and objective than Level 3 inputs, which are based on reporting entity's assumptions about how market participants would value the instrument.

Statement 157 requires fair value measures to maximize the use of observable inputs. Thus a company is not permitted to use its assumptions (unobservable inputs) to measure fair value when market data (observable inputs) are available. However, even when unobservable inputs are used, the measurement objective is the same: the current price that a market participant would receive to sell an asset or pay to transfer a liability.

There may be situations in which an observable (Level 2) input may require adjustment. For example, it would be appropriate to adjust observable market information if the market data is stale, or is based on the sale of an asset with different characteristics, or arises from a transaction in a market with low volumes or infrequent transactions. If the adjustment to the Level 2 input is significant, the end result may be Level 3 measurement.

While the framework and underlying concepts of the hierarchy are clear, putting them into practice when markets are suffering from severe liquidity and credit concerns has generated numerous

questions. Given the significant lack of liquidity in current markets, observable inputs that were previously thought to be reliable and objective now seem less so. Current market conditions have led to extensive discussion surrounding fair value measurement issues such as:

- What constitutes an active market?
- When is a transaction forced or distressed?
- How does one determine if transaction data is “stale”?
- What adjustments, if any, should be made to observable data in this type of market?
- At what point do adjustments to observable data result in those inputs being “unobservable” (i.e., Level 3)?
- Is a pure Level 3 input preferable to a significantly adjusted Level 2 input?

In short, the question revolves around the extent to which observable data should be incorporated in a fair value measurement when that observable data is thought to result from unusual (some would argue “irrational”) market conditions. Specifically, should observable inputs obtained from transactions in a troubled market be incorporated into the valuation or should those inputs be set aside in favor of unobservable inputs such as internal cash flow forecasts and estimates of underlying asset quality?

The VRG was asked how practice is dealing with observable market information during this period of crisis and whether guidance from the FASB would be helpful.

### ***Discussion***

This discussion was essentially a carryover of two prior discussions: VRG Issue No. 2008-07 discussed at the May 2008 meeting and the IASB Expert Panel’s draft document in VRG Issue No. 2008-11 (see above).

There continued to be interest in obtaining clarity from the FASB on what constitutes an active market. There was also keen interest in guidance from the FASB, perhaps in the form of examples, regarding the way in which the fair value measurement could incorporate both current market information from recent transactions as well as unobservable inputs such as internal cash flow forecasts and estimates of underlying asset quality.

There was some further discussion of the distinction between fundamental value and fair value (see VRG Issue No. 2008-11 above.) VRG members appeared to agree on two points:

1. A fair value measure can not ignore current market conditions. In other words, a pure fundamental analysis that assumes an instrument is held until it matures and ignores the current liquidity and credit crisis would not represent fair value because the result does not represent the price at which the asset could be sold today. Even a fair value measure based exclusively on unobservable (Level 3) inputs would need to consider current market conditions because those conditions would be relevant to a market participant.
2. It would be inappropriate to look *solely* to the “last transaction price” for determining fair value unless that price was a Level 1 input. Even without being able to clearly delineate between an “active” and “inactive” market, VRG members agreed that if market participants would adjust the “last transaction price” for factors such as the timeliness of the transaction (how recent it was), the level of activity in the market (how many buyers/sellers there were), the instruments’ differing characteristics (how dissimilar the asset was), etc., then it would be appropriate to adjust the “last transaction price” in determining the instrument’s fair value.

## **VRG Issue No. 2008-14: Fair Value Measurement of Liabilities under FAS 157**

### ***Summary***

The VRG was asked if practice continues to seek guidance from the FASB on determining the fair value of liabilities in situations where legal restrictions prevent the liability from being transferred.

### ***Issue***

Under Statement 157, the fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants. In other words, the fair value of a liability does not presume settlement; rather, it presumes a continuation of the liability with the same nonperformance risk before and after its transfer.

The VRG first discussed this issue in October 2007. At that time, VRG members noted the difficulty in estimating fair value for liabilities that are non-transferrable due to legal or contractual restrictions. Because true transfers of liabilities do not occur in practice, there are no observable markets or inputs. Therefore the measurement of these liabilities under Statement 157's exit value model reflects a purely hypothetical transaction.

Subsequently, the FASB issued a proposed FASB Staff Position (FSP) No. 157-c, *Measuring Liabilities under FASB Statement No. 157*. As noted in prior minutes, VRG members generally thought the proposed guidance would simplify the application of Statement 157 but also noted that the guidance seemed to shift the fair value measurement of liabilities from an exit price to an entry price. The FASB has received comments on that proposal and re-deliberated the proposed FSP. However, as of the date of this VRG meeting, the final FSP has not been issued.

Now that practice has had some experience with measuring liabilities at fair value under Statement 157, the FASB Staff asked the VRG (a) whether there is diversity in practice relative to the valuation of liabilities, and (b) whether guidance on the fair value measurement of liabilities would be helpful to users and preparers.

### ***Discussion***

The discussion on this issue was not extensive. Some VRG members noted that the fair value measurement of a company's debt is particularly difficult for companies whose debt is not publicly traded. While not necessarily carrying the debt at fair value on their balance sheets, these companies may be required to provide fair value information in their footnotes. In particular, these companies have difficulty making adjustments for the effect of changes in their own credit risk. In contrast to entities whose publicly traded debt provides at least some market data (i.e., market data from the liability traded as an asset), companies whose debt is not traded have absolutely no market data to consider. Others noted that privately held companies frequently question the usefulness of a measure of fair value based on a hypothetical transfer of the liability. These companies believe that the principal users of their financial statements (owners and creditors) consider settlement of the liability as the only possible exit strategy.

On balance, VRG members continue to believe that guidance is needed.

## **VRG Issue No. 2008-15: Allocation of In-Use Valuation to Individual Unit of Account**

### ***Summary***

The VRG was asked to consider how to determine the fair value of individual assets in a group when the asset group is valued based on an in-use premise. A top-down approach allocates value to the individual assets so that the sum of the parts equals the whole. A bottom-up approach measures each asset separately using an in-use premise.

### ***Issue***

Valuation measurements are based one of two premises – the asset’s value in-use or the asset’s value in-exchange. Statement 157 requires that the valuation premise be based on the highest and best use of the asset from the perspective of market participants (see paragraphs 12-14 and A6-A12.) When market participants would maximize an asset’s value principally on a stand-alone basis, the valuation premise is in-exchange. This means that the fair value of the asset is based on the selling price of the individual asset, without regard to the asset’s use in combination with other assets. Alternatively, when market participants would obtain maximum value by using the asset in combination with other assets as a group, the valuation premise is in-use. This means that the fair value of the asset is based on the use of the asset together with other assets as a group, even if the asset is accounted for individually. Statement 157 states that the valuation premise should be consistent for all assets within a group. Thus, if an asset is worth more to market participants as a part of a group (i.e., in use), then each asset in the group is valued using the in-use premise.

The valuation premise does not, however, define the unit of valuation. For this reason, when the valuation premise is in-use, some have asked how the fair value of an individual asset within an asset group should be determined. Should the in-use premise result in the fair value of the group of assets being allocated to the individual assets in the group? This view is referred to as a top-down approach in which the sum of the fair values of the individual assets in the group must equal the fair value of the asset group as a whole. Or should the fair value of each asset in the group be determined separately based on its value in-use? This view is referred to as a bottom-up approach.

The confusion inherent in the question may arise from difficulty in reconciling the requirement to determine an exit value with the requirement to value the asset on an in-use basis. Some believe that because the fair value of an asset is the price that would be received if the asset were sold (exit value), an in-use valuation presumes that assets which are used as a group are sold as a group. Under this view, the selling price (or exit value) for the group dictates the fair values of the individual assets within the group. However, that view confuses the notion of ‘exit value’ with the notion of ‘valuation premise.’ An in-use premise does not presume a basket purchase by the market participant. It simply establishes the perspective that the market participant is using to determine the price it is willing to pay. In other words, the market participant is evaluating the asset’s value based on the asset’s use in combination with assets that are otherwise available to the market participant. Thus, the price the seller will receive from the sale of the asset, that is, the exit value, is from the perspective of a market participant who plans to use - rather than sell - the asset.

VRG members were asked whether the top-down or bottom-up approach was used in practice to determine the fair value of an asset when the valuation premise is in-use.

### ***Discussion***

VRG members were essentially unanimous that the bottom-up approach is used in practice.

[Author’s Note: The VRG previously discussed a fact pattern involving the in-exchange valuation premise. See VRG Issue No. 2007-12, “Highest and Best Use – land example” in the November 2007 minutes.]

**VRG Issue No. 2008-16:  
Fair Value of Accounts Receivable, Accounts Payable, and Other Accrued  
Liabilities**

***Summary***

VRG members were asked how accounts receivable, accounts payable and other accrued liabilities acquired in a business combination will be valued under Statement 157.

***Issue***

The requirement to use the fair value measurement concepts in Statement 157 in a business combination becomes effective in 2009 when FASB Statement No. 141 (Revised 2007), *Business Combinations*, is adopted.

Prior to Statement 141R, GAAP required accounts receivable, accounts payable and accrued liabilities acquired in a business combination to be valued at the present value of amounts to be received or paid determined at current interest rates (see paragraphs 37(b), (g) and (j) of FASB Statement No. 141, *Business Combinations*.) In practice, most entities used carryover book values on the basis that there would not be a material difference between the present value and face amounts of such short term assets and liabilities.

Under Statement 157, the values of accounts receivable, accounts payable and accrued liabilities should be determined based on exit values. For accounts receivable, that is the price received upon sale of the assets; for accounts payable and accrued liabilities, that is the price that would be paid upon transfer of the liabilities to a third party with an equivalent risk of nonperformance.

Some believe (View A) that under Statement 157, the fair value of accounts receivable (trade receivables or loans receivable) should be based on the sale of the assets to a market participant, thus incorporating the market's assessment of credit risk, timing of receipts, and appropriate return (profit margin) on the portfolio. Similarly, the fair value of the accounts payable and accrued liabilities should be based on a transfer of those liabilities to a market participant, thus incorporating the timing of payments, current interest rates and an appropriate profit margin to service the liabilities.

Others believe (View B) that because these specific assets and liabilities are an integral part of the acquired business' working capital, the fair value under Statement 157 should be based on more of an in-use premise. Under this view, the fair value of accounts receivable would be based on the present value of amounts to be received at appropriate interest rates, after considering collection costs and uncollectible amounts. Similarly the fair value of accounts payable and accrued liabilities would be based on the present value of amounts to be paid based on appropriate discount rates.

***Discussion***

VRG members agreed that practice has historically approached the valuation of accounts receivable, accounts payable and accrued liabilities principally using carryover basis. Only when receivables had extended payment terms at below market interest rates would a present value approach be used.

Regarding Views A and B under Statement 157 and Statement 141R, VRG members debated whether the two approaches would yield materially different values, some saying "no" because the amounts are so short term, others saying "yes" because of the profit element that a market participant would demand in a sale of the assets or transfer of the liabilities.

It was not clear to the group that there would be only one acceptable approach in all fact patterns. In some circumstances the approach outlined in View A might be preferable to View B; in other situations the inverse might be true. The discussion focused principally on trade receivables and trade

payables, including factors such as liquidity, duration, and credit standing. There was an acknowledgment that little consideration had yet been given to accrued liabilities.

## **VRG Issue No. 2008-17: Identification and Allocation of Market Participant Synergies**

### ***Summary***

VRG members were asked whether different approaches to identifying and allocating market participant synergies will result in significant diversity in practice.

### ***Issue***

Statement 141R indicates that synergies are a component of goodwill. It acknowledges that expected synergies and other benefits from combining the target's business with the acquirer's business are unique to each business combination. Thus different combinations would produce different synergies and, hence, different values (paragraph B133.) However, while noting that entity-specific synergies are a component of goodwill, Statement 141R does not discuss the concept of allocating synergies between market participant synergies (i.e., synergies that would be available generally to market participants) and entity-specific synergies (i.e., synergies that are unique to the acquirer).

Statement 157 discusses the concept of market participant synergies when measuring the fair value of assets in a business combination. Implicit in Example 1 of Appendix A to Statement 157 is the acknowledgment that different market participants may be able to realize different synergies because of the interaction between the target's assets with the acquirer's own assets. In Example 1, market participants who are strategic buyers have a different perspective on the value of an asset group that includes billing software than do market participants who are financial buyers. That is, in part, because strategic buyers have a substitute for the billing software. The result is that strategic buyers have a different set of synergies amongst the assets in the group than do financial buyers. However, that example is used to illustrate the concept of highest and best use and does not explicitly address the allocation of synergies between goodwill and individual assets. Further, the example demonstrates the subjectivity involved in distinguishing between entity-specific synergies and market participant synergies. On the one hand, one could argue that having a substitute for the billing software is an entity-specific synergy. However, when other market participants also have a substitute asset, Statement 157 suggests that the synergy relates to market participants.

The AICPA Practice Aid, "Assets Acquired in a Business Combination to be Used in Research and Development Activities" (the IPR&D Guide), states that synergies should be divided between market participant synergies and entity-specific synergies. The former - market participant synergies - would be attributed to an identifiable asset and the latter - entity-specific synergies - would be attributed to goodwill. In fact, the IPR&D Guide illustrates how entity-specific synergies would be excluded in the application of the multi-period excess earnings method (income approach).

VRG members were asked to consider whether significant diversity in practice will result from the lack of specific guidance in Statement 157, particularly given the prior guidance in the IPR&D Guide. The question was posed with respect to both tangible and intangible assets.

### ***Discussion***

It was noted that the AICPA plans to update the IPR&D Guide. The AICPA had initially decided to stop selling the current edition of the guide. However, because Statement 141R is not effective until next year, they have been making it available as a "pdf file" with the specific caveat that it has not been updated.

VRG members noted that this issue historically has had no relevance to tangible assets and thus

probably would not create diversity in practice related to those valuations. However, some observed that the broader definition of a business might result in goodwill for a transaction that previously was viewed as a basket purchase of assets. Thus the issue become relevant for tangible assets in the future.

VRG members also noted that, in practice, synergies that are deemed generally available are considered when valuing an individual asset whereas entity-specific synergies are not. Typically this is not a conceptual issue but rather one of documentation or estimation, that is, how to demonstrate that only market participant synergies are included in the valuation of an individual asset.

## **VRG Issue No. 2008-18: Fair Value of a Noncontrolling Interest and a Previously Held Equity Interest**

### ***Summary***

VRG members were asked to consider whether a control premium should be allocated to a previously held noncontrolling interest for purposes of determining the gain or loss to be recorded when control is obtained. This question arises when there is a step acquisition, for example, when the acquisition of an initial 35% interest is followed by a subsequent purchase of a 40% interest and the purchase of the 40% interest includes a control premium.

### ***Issue***

Under Statement 141R, a previously held noncontrolling interest should be measured at fair value when control is obtained. The difference between the noncontrolling interest's carrying value and its fair value at the time control is obtained is recognized in income as a gain or loss (paragraph 48 of Statement 141R.) When a control premium is paid, the question is whether any of the control premium relates to the previously held noncontrolling interest. The answer to this question has a direct effect on the amount of gain or loss reported from the remeasurement of the previously held interest.

For example, assume Company A purchases 35% of Company B for \$350 (35 shares at \$10 a share) on June 1, 2010. The 35% interest is accounted for under the equity method. A year later, on June 1, 2011, Company A purchases an additional 40% of Company B for \$2,000 (40 shares at \$50 a share), giving Company A a controlling 75% interest in Company B. However, the market float of Company B at June 1, 2011 was \$40 a share. Thus Company A paid a premium of \$400 (\$50 actual price - \$40 market price × 40 shares) to obtain control. Company A is required to remeasure its 35% equity method interest in Company B at fair value as of June 1, 2011 and report a gain (or loss) in income. The question is whether the \$400 control premium relates to the prior 35% interest or to the recently purchased 40% interest or perhaps to both. The confusion arises because the 40% interest itself does not represent a controlling interest. In other words, had Company A not previously owned a 35% interest, it would have paid only \$1,600 (\$40 a share) for its 40% interest. Therefore it is not clear whether the control premium relates to the 40% interest or to the previously owned the 35%, or to both. [Author's Note: The remaining 25% noncontrolling (minority) interest in Company B must also be reported at fair value on Company A's books on June 1, 2011, that is, at the time control is obtained. It is clear that no portion of the control premium is allocated to that 25% interest. In this example, the 25% interest would be valued at \$40 per share.]

### ***Discussion***

VRG members agreed that this was an accounting issue, not a valuation issue. From a valuation perspective, the shares of Company B owned by Company A are completely fungible and thus no individual share is worth any more or less than any other share. This would imply that the control premium is allocable pro rata to each individual share. However, from an accounting perspective, the notion underlying the remeasurement is that in substance two discrete transactions have occurred – the noncontrolling interest was sold (35 shares, in the example above), resulting in a gain or loss, and a controlling interest was obtained (75 shares, in the example above). Said differently, the unit of

account that is being measured at fair value for the noncontrolling interest is an individual share of stock. Thus, the fair value of the previously held noncontrolling interest is measured as  $P \times Q$ : the market price of an individual share of stock (P) times the number of shares held (Q). In the example above, the fair value of the previously held interest is  $P (\$40) \times Q (35) = \$1,400$ ; consequently, none of the control premium would be allocated to the previously held 35% interest for purposes of computing the gain or loss.

The FASB staff will consider whether any formal guidance on this issue should be provided.

## Other Matters

- The VRG did not discuss Issue No. 2008-19, “Impact of valuing contingent liabilities under Statement 141(Revised) - gross versus net analysis” which was scheduled to be discussed at this meeting. The issue addresses the effect of a contingency on the valuation of an asset. For example, if an identifiable intangible asset such as a patent or trademark is the subject of litigation at the time of the acquisition, how should the litigation be factored into the valuation of the intangible asset? The FASB staff indicated that it plans to ask the FASB to reconsider aspects of the contingent liability/contingent asset model in Statement 141R in early October. Accordingly, the VRG issue is postponed pending the FASB’s decision on the broader topic of contingent assets and contingent liabilities.
- The FASB staff noted that it is still considering the need for additional guidance on the effect of restrictions on the valuation of an asset. Refer to VRG Issue No. 2008-8 from the May 2008 meeting for previous discussion.
- The FASB staff noted that it is also working with the AICPA staff regarding the need for additional guidance on the valuation of participant loans in the financial statements of an employee benefit plan. Refer to VRG Issue No. 2008-9 from the May 2008 meeting for previous discussion.

## Appendix

This Appendix identifies all the issues discussed by the VRG to date. Minutes for other meetings beginning in November 2007 are available on Accounting Research Manager<sup>®</sup>. No minutes are available for the VRG's initial meeting in October 2007.

### October 2007:

- VRG Issue No. 2007-1: Fair Value of Mortgage Loans
- VRG Issue No. 2007-2: Unit of account – Decomposition of an Asset
- VRG Issue No. 2007-3: How to Factor Liquidity into Fair Value Measures [*Author's Note: See also VRG Issue No. 2008-7 in May 2008 and VRG Issue No. 2008-11 and VRG Issue No. 2008-13 in September 2008. Reference should also be made to the white papers on liquidity in the markets issued by the Center for Audit Quality in CAQ Alert 2007-51*]
- VRG Issue No. 2007-4: Elements of Consideration for Determination of “Active Market” [*Author's Note: See also VRG Issue No. 2008-7 in May 2008 and VRG Issue No. 2008-11 and VRG Issue No. 2008-13 in September 2008.*]
- VRG Issue No. 2007-5: Determination of a Principal Market
- VRG Issue No. 2007-6: Highest and Best Use: Defensive Value [*Author's Note: See also VRG Issue No. 2008-1 in February 2008. Additionally, as of September 23, 2008, the EITF is discussing 'day two' accounting issues related to acquired assets whose value is based on a defensive position. See EITF Issue No. 08-07, "Accounting for Defensive Intangible Assets."*]
- VRG Issue No. 2007-7: Assets Acquired through an Auction
- VRG Issue No. 2007-8: Assets and Liabilities without Markets
- VRG Issue No. 2007-9: Pension Plan Disclosures [*Author's Note: As of September 23, 2008, an FASB Staff Position is in process related to fair value disclosures for pension assets in the employer's financial statements. See proposed FASB Staff Position (FSP) FAS No. 132(R)-a, "Employers' Disclosures about Postretirement Benefit Plan Assets."*]
- VRG Issue No. 2007-10: Use of Net Asset Value in Fund of Funds Investments

### November 2007:

- Potential deferral of Statement 157 [*Author's Note: Statement 157 was partially deferred as documented in FASB Staff Position (FSP) 157-2, "Effective Date of FASB Statement No. 157."*]
- Potential FASB guidance on development of market participant assumptions
- Unit of valuation/exit markets

- Measurement of liabilities [*Author's Note: As of September 23, 2008, an FASB Staff Position is in process related to measurement of liabilities. See FSP FAS 157-c. Also see discussion of VRG Issue No. 2008-14 in September 2008.*]
- Applicability of Statement 157 disclosures to plan assets of pension or other postretirement benefit plans [*Author's Note: As of September 23, 2008, an FASB Staff Position is in process related to fair value disclosures for pension assets in the employer's financial statements. See FSP FAS No. 132(R)-a*]
- VRG Issue No. 2007-11: Fair Value of a Liability with Third-Party Guarantees [*Author's Note: The EITF subsequently discussed this issue and has reached a final consensus. See EITF Issue No. 08-05, "Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement."*]
- VRG Issue No. 2007-12: Highest and Best use – land example [*Author's Note: For a similar issue, see VRG Issue No. 2008-15 in September 2008.*]
- VRG Issue No. 2007-13: Definition of “significant” in Evaluating Inputs for Fair Value Hierarchy Classification
- VRG Issue No. 2007-14: Accounting for Transaction Costs in Determining the Fair Value of an Investment. [*Author's Note: As of September 23, 2008, the EITF is discussing a somewhat related issue, specifically, how transaction costs should be accounted for when an equity method investment is acquired. See EITF Issue No. 08-06, "Equity Method Investment Accounting Considerations."*]

#### **February 2008:**

- VRG Issue No. 2008-1: Accounting for Assets that the Acquirer Does Not Intend to Use or Intends to Use in a Way Other Than its Highest and Best Use [*Author's Note: This VRG issue is related to defensive assets. As of September 23, 2008, the EITF is discussing 'day two' accounting issues related to acquired assets whose value is based on a defensive position. See EITF Issue No. 08-07, "Accounting for Defensive Intangible Assets."*]
- VRG Issue No. 2008-2: Customer Relationships
- VRG Issue No. 2008-3: Valuation of Intangible Assets Using Current Replacement Cost
- VRG Issue No. 2008-4: Meaning of Legally Permissible in Assessing Highest and Best Use
- VRG Issue No. 2008-5: Fair value of Finished Goods Inventory
- VRG Issue No. 2008-6: Allocation of Portfolio Based Credit Adjustments for Hedge Effectiveness Testing

#### **May 2008:**

- VRG Issue No. 2008-7: Observable vs. Unobservable Fair Value Measurements in the Current Credit Environment [*Author's Note: See two related discussions at the September 2008 meeting: VRG Issue No. 2008-11 and VRG Issue No. 2008-13.*]

- VRG Issue No. 2008-8: Determining whether a discount should be applied for a restriction on the sale of an asset
- VRG Issue No. 2008-9: Employee Benefit Plans
- VRG Issue No. 2008-10: Contingent Liabilities

**September 2008:**

- VRG Issue No. 2008-11: IASB Expert Advisory Panel white paper - Measuring and disclosing the fair value of financial instruments in markets that are no longer active *[Author's Note: Other discussions related to this topic include VRG Issue No. 2008-7 in May 2008 and VRG Issue No. 2008-13 in September 2008. Also see the white papers on liquidity in the markets issued by the Center for Audit Quality in CAQ Alert 2007-51.]*
- VRG Issue No. 2008-12: Fair Value Disclosures *[Author's Note: The SEC staff has written two letters recommending disclosure of additional information related to fair value measures. See letter dated March 27, 2008 and letter dated September 16, 2008.]*
- VRG Issue No. 2008-13: Observable vs. Unobservable Inputs *[Author's Note: Other discussions related to this topic include VRG Issue No. 2008-7 in May 2008 and VRG Issue No. 2008-11 in September 2008. Also see the white papers on liquidity in the markets issued by the Center for Audit Quality in CAQ Alert 2007-51.]*
- VRG Issue No. 2008-14: Fair Value Measurement of Liabilities under FAS 157 *[Author's Note: As of September 23, 2008, an FASB Staff Position is in process related to measurement of liabilities. See proposed FSP FAS No. 157-c.]*
- VRG Issue No. 2008-15: Allocation of In-Use Valuation to Individual Unit of Account *[Author's Note: For a similar issue, see VRG Issue No. 2007-12 in November 2007.]*
- VRG Issue No. 2008-16: Fair Value of Accounts Receivable, Accounts Payable, and Other Accrued Liabilities
- VRG Issue No. 2008-17: Identification and Allocation of Market Participant Synergies
- VRG Issue No. 2008-18: Fair Value of Noncontrolling Interest and Previously Held Equity Interest