

# Alert

September 2006

## Worthless to You But Valuable to a Market Participant? New Fair Value Rules Require Valuation of Assets to be Abandoned

*“Notably, this (fair value) definition focuses on exit values, e.g. the value when an asset is sold, rather than entrance values.”*

In response to the need for consistent fair value measurement guidance, the FASB has issued its long-awaited Statement of Financial Accounting Standards (SFAS), No. 157, *Fair Value Measurements*. The Standard, which applies to nonfinancial assets and liabilities, is effective for fiscal years beginning after November 15, 2007.

SFAS 157 has major implications with respect to accounting for assets, such as trademarks, patents, or software, which an acquirer plans to abandon after an acquisition. Under the new rules, if a company has an asset that is not going to be actively used in the reporting entity's business, but is being retained for defensive purposes, it will still have to assign a value to the asset. In a situation where a market participant would find value in using this type of asset standalone in the market place, the asset would need to be valued based on what a market participant would pay for it.

In addition, the asset would have to be tested annually for impairment. In future reporting periods, this analysis could result in an impairment charge relating to the asset and would add to the reporting entity's requirements to properly address this type of asset for financial reporting purposes.

The following is a review of the main points contained in SFAS 157.

### MARKET PARTICIPANT ASSUMPTIONS

SFAS 157 requires that fair values be based on the perspective of a "market participant." Consideration of the market participant's viewpoint in fair value estimates is not new; the use of market-participant assumptions is mandated in Statements 141, 142, and 144. For example, when determining fair value in the context of an impairment, both Statements 142 and 144 provide for the use of market participant assumptions when that information is "available without undue cost and effort." Otherwise, an entity's own assumptions may be used.

### DEFINITION OF FAIR VALUE

Fair value is defined in SFAS 157 as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market which would be the most advantageous for the asset or liability." Notably, this definition focuses on exit values, e.g. the value when an asset is sold, rather than entrance values.

### FAIR VALUE HIERARCHY

SFAS 157 identifies a fair value hierarchy to rank the reliability of inputs used in a valuation approach. The first – and highest – level refers to quoted prices for identical assets or liabilities in an active market. When those prices are not available, the second – or middle – level will base fair value estimates on observable inputs that a market participant would use. If observable

*continued on back...*

## Worthless to You But Valuable to a Market Participant?

...continued from front

*“A valuation expert exercises judgment in deciding which approaches to use and in weighing the various value conclusions in order to select the most appropriate value.”*

inputs are not available, the third – and lowest – level will require the use of unobservable inputs. However, the objective of fair value remains the same and thus even unobservable inputs will need to incorporate the assumptions a market participant would use in developing an exit price. The reporting entity's own data may be used to develop unobservable inputs, provided that information which shows that market participants would use different assumptions is not readily available with undue cost and effort.

### VALUATION PREMISE

The valuation premise used to measure the fair value of an asset depends on the highest and best use of the asset by market participants. Highest and best use refers to how an asset or group of assets would be used by a marketplace participant so as to maximize the value of the asset or the group of assets in which the asset would be used. It's important to note that highest and best use is based on the market participant's use of the asset, regardless of the intended use of the asset by the reporting entity. Market participants, generally classified as strategic buyers and financial buyers, would likely assign different values to an asset depending on how each group intends to use the asset.

### VALUATION APPROACHES

SFAS 157 states that valuation techniques consistent with the market approach, income approach and/or cost approach should be used to estimate fair value. Selection of a valuation method, or multiple valuation methods, will depend on the nature of the item being valued as well as the availability of data. For example, the final standard is expected to indicate that a single valuation technique may be appropriate when valuing an asset or liability for which quoted prices in an active market for an identical item are available. In contrast, multiple valuation techniques may be appropriate when valuing a reporting unit.

Valuation specialists are required by professional valuation standards and practices to consider all three approaches, but they may choose not to apply one of the approaches, particularly if the results of the approach would not be relevant, or if the data needed to employ the approach is not available. A valuation expert exercises judgment in deciding which approaches to use and in "weighing" the various value conclusions in order to select the most appropriate value.

### FSP TO BE ISSUED

Along with the release of SFAS 157, the FASB has decided to issue a FASB staff position (FSP), which will address the use of entity-specific assumptions rather than market-participant assumptions to measure fair value of nonfinancial assets and liabilities under Statements 141, *Business Combinations*, 142, *Goodwill and Other Intangible Assets*, and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. For more information, contact your Valuation Research representative or Jeff Trader at (414) 221-6250. **VR**

Editor: Theresa Miller

© Valuation Research Corporation. All rights reserved.

**Valuation  
Research**<sup>®</sup>  
Corporation

**Valuation Research Corporation**  
Corporate Office:  
330 East Kilbourn Avenue  
Milwaukee, WI 53202  
414.271.8662

[www.valuationresearch.com](http://www.valuationresearch.com)

Boston	617.342.7366
Chicago	630.242.1950
Cincinnati	513.579.9100
Milwaukee	414.271.8662
New York	212.983.3370
Princeton	609.452.0900
San Francisco	415.277.1800
Tampa	813.639.7691

#### International Affiliates:

Argentina  
Australia  
Brazil  
Chile  
China  
Mexico  
Spain  
United Kingdom  
Venezuela