

The Evolution of Market Participants and Their Relevance to Fair Value Measurements



AICPA Practice Aid

Assets Acquired in a Business Combination to be used in Research and Development Activities: A focus on Software, Electronic Devices, and Pharmaceutical Industries

- Attempted to distinguish fair value, as defined in the accounting literature, from other potential premises of value.
- Liquidation value, either forced or orderly, suggests that the seller is compelled to sell. And the Practice Aid concluded that liquidation value is an appropriate basis for determining fair value only in those cases where an asset has been identified for immediate disposal.
- Investment value, on the other hand, was described as synergistic or strategic value to a particular buyer with specific expectations about future events, cost of capital, tax position, and other issues. The Practice Aid concluded that investment value is not an appropriate basis for determining fair value, as it would encompass benefits expected by a particular buyer of the asset that are different from those available to market participants in general.



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- The Practice Aid referred to the hierarchy in GAAP for evidentiary matter to be used in determining fair value, with quoted market prices in active markets being the best evidence of fair value.
- However, it is recognized that quoted market prices do not exist for most intangible assets, and that other valuation methods must be employed.
 - Present value of estimated future cash flows using risk-adjusted discount rates.
 - Present value of probability-weighted future cash flows using a risk-free discount rate.
 - Option pricing models.
- But, those methods should incorporate assumptions that market participants would use in their estimates of future revenues, future expenses, and required rates of return.



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- The Practice Aid also presumed that, absent evidence to the contrary, the assumptions used by the acquiring company and the acquired company in negotiating the value of the consideration exchanged in the transaction is indicative of the assumptions that market participants would use in making estimates of fair value.
- If the buyer's projected financial information includes strategic or synergistic benefits in excess of those expected to be realized by market participants, the valuation specialist is required to identify those excess benefits and remove them from the valuation of the assets.
- The Practice Aid stated that market participants include all potential buyers (other than financial buyers and investors that would not intend to take an active role in managing the acquired business) whether or not the potential buyers are engaged in discussions with the seller of the business.
- The valuation specialist would consider as market participants only those potential buyers with the financial wherewithal, or ability to obtain it, as well as a plausible post combination operating strategy for the assets being valued.
- Market participants would include competitors in the same line of business as the company being acquired.



ASC Topics 805 & 350

- ASC Topic 805 (f/k/a SFAS 141), Business Combinations, paragraph 37, states that the portion of the purchase price assigned to an asset is affected by the acquiring company's plans for that asset.
 - Fair value in use
 - Fair value in exchange
 - Salvage value.



ASC Topics 805 & 350

- ASC Topic 350 (f/k/a SFAS 142), Goodwill and Other Intangible Assets, paragraph 24, states that when measuring the fair value of a Reporting Unit, the estimates of future cash flow shall be consistent with the objective of measuring fair value, and shall incorporate assumptions that marketplace participants would use in their estimates of fair value, such as assumptions about contract renewals and other benefits, such as those that might result from acquisition-related synergies. It makes a distinction between synergies available to market participants, which are includable in the determination of fair value, and entity-specific synergies, which may not be considered, as they result in investment value.
- In summary, the concept of market participants was limited to the assumptions contained in developing estimated future cash flows, whereby entity-specific synergies were eliminated. Such assumptions as revenue growth rates, cost structure, levels of capital investment, reinvestment in working capital, and required rates of return were supported by research into the historical results of operations of the acquired company and its industry peers, analyst reports on prospects for the industry, and reports of analysts following the peer group. But the fair value was determined in accordance with the intended use of the asset by the specific buyer.



ASC Topic 820

- ASC Topic 820 (f/k/a SFAS 157), Fair Value Measurement, issued in September 2006 does three things:
 - Defines fair value for financial reporting purposes.
 - Establishes a framework for measuring fair value under GAAP.
 - Expands disclosures about fair value measurements.
- Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”
- While this definition retains the exchange price notion in earlier definitions of fair value, the transaction to sell the asset (or transfer the liability) is a hypothetical transaction considered from the perspective of a market participant that holds the asset (or owes the liability).
- When an asset is acquired, the transaction price represents the price paid to acquire the asset, whereas the fair value of that asset is the price that would be received to sell the asset. Conceptually, entry prices and exit prices are different.
- Paragraph 17, however, lists four criteria to determine when the transaction price might not represent fair value, and states that in many cases the transaction price does in fact represent fair value at the transaction date.



ASC Topic 820

- Market participants are more fully defined in ASC Topic 820 as buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:
 - Independent of the reporting entity; that is, they are not related parties
 - Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary
 - Able to transact for the asset or liability
 - Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.
- ASC Topic 820 carries forward the requirement that the fair value of the asset shall be determined based on the assumptions that the market participants would use in pricing the asset.
- While the reporting entity need not identify specific market participants, it should identify characteristics that distinguish market participants generally.
- Moreover, market participants are not limited to strategic buyers, as in the Practice Aid, but could include financial buyers as well.



ASC Topic 820

- ASC Topic 820 says that valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs.
- Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset developed based on market data obtained from sources independent of the reporting entity.
- Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset developed based on the best information available in the circumstances.



ASC Topic 820

- The fair value measurement also assumes the highest and best use of the asset by market participants, considering what is physically possible, legally permissible and financially feasible at the measurement date.
- The highest and best use of the asset is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.
- Because the highest and best use of the asset is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset.



ASC Topic 820

- The concepts of exit price, highest and best use, in-use and in-exchange valuation premises, and market participant perspective should be considered collectively when measuring fair value. Examples within the Implementation Guidance support this notion.
- The first contrasts the values of three assets of a target to a strategic buyer with the value of the same assets to a financial buyer. The values to the strategic buyer are \$360, \$260, and \$30, for a total of \$650. The values of the same assets to a financial buyer are \$300, \$200, and \$100, for a total of \$600. Since the total value of the asset group to the strategic buyer exceeds the total value to the financial buyer, the fair values of the three assets would be determined based on the use of the assets as a group to the strategic buyer. Although the use of the assets to the strategic buyer does not maximize the fair value of each of the assets individually, it maximizes the fair value of the assets as a group.
- The second addresses the value of land currently developed for industrial use. However, nearby sites have been rezoned and developed for residential use as sites for high-rise condominiums. The highest and best use of the land would be determined by first determining the fair value of the manufacturing operations, which includes the land, land improvements, and M&E. This value is compared to the value of the land vacant and available for residential use, considering the demolition costs, and ascribing scrap or liquidation value to the M&E. The higher of those two values would form the basis of the valuation of the land.



2007 Revision of then SFAS 141

- The revised version of then SFAS 141 (now ASC Topic 805), issued in December 2007, incorporates the concepts of fair value measurement of ASC Topic 820. Namely, the fair value of the assets should be determined based on their highest and best use incorporating the assumptions of market participants.
- In the Implementation Guidance, paragraph A59 states: For competitive or other reasons, the acquirer may intend not to use an acquired asset, for example, a research and development project intangible asset, or it may intend to use the asset in a way that is not its highest and best use. Nevertheless, the acquirer shall measure the asset at its fair value determined in accordance with Statement 157 reflecting its highest and best use in accordance with the appropriate valuation premise, both initially and for purposes of subsequent impairment testing.
- In the Basis for Conclusions, paragraph B262 confirms this position, stating that the intention of ASC 805 is that assets, both tangible and intangible, be measured at their fair values regardless of how or whether the acquirer intends to use them.



2007 Revision of then SFAS 141

- In the Basis for Conclusions, paragraph B251 states that an exit price for an asset acquired in a business combination would differ from an exchange price (entry or exit) only if the asset is acquired for its defensive value.
- But there are instances where assets acquired in a business combination will be abandoned by the buyer, even though they may have use to another market participant.
 - Trade names
 - Certain IPR&D projects
- Here, the alternative argument may rest on aggregating assets into a group (target's technology with acquirer and trade name) to demonstrate "highest and best use."



Valuation of Privately Held Company Equity Securities Issued as Compensation

- Discusses the three traditional approaches to valuation: Market, Income and Cost.
- In many cases, the Income Approach is based on entity-specific assumptions.
- But, these assumption should be consistent with the assumptions market participants would use in valuing an interest in the enterprise.
- Valuer must consider the cash flows that market participants would expect the enterprise to generate under current ownership through the anticipated liquidity event.
- Practical limitations in application of PWERM framework: relies on subjective management assumptions.

SUMMARY

- Practitioners have incorporated into their analyses of fair value documentation of observable inputs which market participants would use in the pricing of assets.
- Practitioners have also incorporated documentation needed to support the reasonableness of unobservable inputs, or assumptions that market participants would make in estimating the fair value of an asset, such as revenue growth rates, cost structure, and needs for reinvestment.
- But ASC Topic 805 has opened the door to valuing individual assets based on market participant uses, which are different from the actual buyer's. Assuming that a valuer had access to such information, which is doubtful, does this produce better accounting?
- Management makes many decisions regarding the development of a firm's capital: constructing new facilities, expanding into new market territories, conducting R&D for new technologies, and acquiring companies. Accounting rules struggle to provide the data investors need to evaluate the soundness of these decisions, and management's ability to execute the strategies. Does stepping away from management's intended use of an asset, and imposing valuations based on alternative and speculative uses of the assets acquired through business combinations improve such accounting information?

