

Current Valuation Issues

STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 157 *Fair Value Measurements*

Effective Date (Non-Financial Assets/Liabilities): November 15, 2008

Industry Focus: Media and Entertainment

Overview

The objective of FASB SFAS 157 is to improve the consistency and transparency of company financial valuation practices as they relate to generally accepted accounting principles (GAAP). These objectives are addressed in three ways. The statement defines fair value, creates a framework for measuring fair value, and defines additional disclosure requirements. The statement improves consistency in the application of valuation practices but at the same time increases the complexity of the financial reporting process.

Key Issues

Certain key differences from previous practice include:

1. Fair value is based upon a hypothetical price that would be received to sell the asset or transfer the liability.
2. SFAS 157 fair value measurement is not “entity-specific” but is a market participant form of measurement.
3. If appropriate, fair value measurement should include adjustments for risk inherent in the valuation technique.
4. The effect of any restrictions associated with the asset should be taken into consideration. In the case of liabilities, this may include non-performance (not fulfilled) risks.

5. Disclosure rules have been expanded to include specific discussion on valuation assumptions and inputs and to lay out the results developed using different methods considered in the analysis.

Definition of Fair Value

SFAS 157 defines fair value 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.”¹ The statement requires the practitioner to consider the specific nature of the asset or liability. The asset or liability can be valued as a standalone item or as a part of a group depending upon how market participants intend to use the item. In the valuation, the specific attributes of the asset or liability should be evaluated including how it is to be used and whether there are any associated restrictions or limitations.

Valuation Framework

The definition of fair value is that price which would be realized if the asset or liability were sold. This is referred to as the exit price. The exchange should reflect the following criteria:

1. The transaction should be an “orderly” transaction between “market participants.”² The value reflects a hypothetical sale where the buyer and seller are not forced to partake in a sale or exchange. The hypothetical sale of the asset or liability assumes that there will be a reasonable time to market the item.
2. The hypothetical transaction of the asset or liability is assumed to take place in the principal (most advantageous) market for such an item, where it will realize the maximum sales price.

¹ Original Pronouncements as Amended, SFAS No. 157, *Fair Value Measurements*, p. FAS 157-6.

² A final FASB Staff Position (FSP FAS 157-4) was issued in April 2009 (effective June 15, 2009) relating to the fair value of financial assets when there is not an active or orderly market. It reaffirms the definition of fair value and provides guidance when there has been a substantial decline in market activity. When a market becomes inactive, further analysis and judgment would be required to determine if the price warrants significant risk adjustments.

3. The value should not include transaction costs, with the exception of transportation costs to locate the asset or liability at its most advantageous market.
4. Market participants are assumed to be independent of the reporting business, knowledgeable, and able and willing to acquire the asset or liability. Fair value is based upon the assumptions that a market participant would consider to price the asset or liability.

Fair value measurement applies to both the assets and liabilities. In consideration of the asset, the following criteria apply:

1. The asset should be measured based upon its highest and best use from the perspective of market participants. Highest and best use considers factors such as:
 - a. In use – The asset may maximize its value alone or in combination with other assets. If in combination with other assets, market participants should have access to those assets. In the event the use of the asset generates economic synergies, the synergies shall be taken into account in the fair value analysis.
 - b. In exchange – The highest and best use may be in-exchange and would typically be on a stand-alone basis.
2. Highest and best use is based upon the use by market participants.

In the case of liabilities, fair value must account for the non-performance risk of the liability, “the risk that the obligation will not be fulfilled,” as well as the credit risk of the reporting unit (“credit standing”).³

In May 2009, FASB released FSP FAS 157-f to provide guidance on measuring liabilities.⁴ Certain liabilities trade as assets in the marketplace, while others are not exchanged due to certain restrictions. Observable inputs may include a quoted price of an identical or similar liability if traded as an asset in an active or inactive market or an income approach based upon the amount a transferring entity would receive. Additional adjustments to the quoted prices or results may be required.

³ Original Pronouncements As Amended, SFAS No. 157, *Fair Value Measurements*, p. FAS 157-8.

⁴ Proposed FASB Staff Position, No. FAS 157-f, *Measuring Liabilities under FASB Statement No. 157*, date released May 1, 2009.

Fair Value Measurement

Three valuation methods are used to determine fair value. These techniques include the market, income, and cost approach. The market approach considers transactions which are comprised of similar or identical assets or liabilities. There may be an actively traded market with daily quoted prices for an identical item or valuation may rely upon market multiples for similar items. The selection of market multiples requires the judgment and consideration of both quantitative and qualitative factors.

The income approach converts future cash flows into a present value based upon market expectations. Techniques such as the Black-Scholes-Merton formula and multi-period excess earnings methods are commonplace.

The cost approach is based upon the cost to place the asset in service from a market participants standpoint, adjusted for depreciation and obsolescence.

Two other key considerations in the application of the technique include the number of valuation methods and consistency factors. In certain cases, a single method may be valid. If multiple techniques are used, the results can be weighted and evaluated as necessary to determine fair value. Within this context, “fair value measurement is the point within that range which is most representative of fair value in the circumstances.”⁵ With respect to consistency, a change in valuation technique or assumptions may be appropriate as additional surfaces, markets change, or methods improve.

SFAS 157 delves deeper into valuation techniques than any previous pronouncements as it defines the type of inputs or assumptions used in the model and establishes a “fair value hierarchy” to be used in the application of valuation models.

The statement defines inputs as observable and unobservable. Observable inputs are those that are based upon market data that a market participant would use to price an asset or liability. Unobservable inputs are those assumptions developed by the reporting entity based upon the most reliable data available at the time. Ideally, fair value techniques should minimize the use of unobservable data.

SFAS 157 creates a hierarchy of inputs to prioritize assumptions and improve consistency. Inputs are defined as follows:

⁵ Original Pronouncements as Amended, SFAS No. 157, *Fair Value Measurements*, p. FAS157-10.

1. Level 1 – These inputs are quoted prices for identical assets and liabilities in an active transaction market where prices are frequently quoted. However, there may be situations where the quoted price does not reflect fair value and price adjustments need to be made. If so, the fair value measurement would be categorized at a lower level.
2. Level 2 – Level 2 inputs are not quoted prices but are directly observable for the asset or liability. These may include prices for similar items, quoted prices for items in an inactive market, or inputs that are developed from observable data (market multiples). It may be appropriate to adjust Level 2 prices based upon specific situations, but like Level 1 adjustments, it may render the input to a lower measurement category.
3. Level 3 – These are unobservable inputs and are relied upon when there is an inactive market. These assumptions are to be developed based upon the best information available and may include management’s own assumptions.

The method eventually selected to establish fair value may be determined by the relative reliability of the assumptions utilized in the analysis.

Disclosure

Disclosure requirements vary based upon whether an asset or liability are to be valued on a recurring basis after the initial recognition, as in the case of trading securities. The reporting entity must report data in its financial statements that allows users to analyze the inputs used in the fair value calculation. Disclosures include reporting:

1. Fair value as of the reporting date
2. The level of inputs (Level 1,2,3) in the fair value hierarchy
3. Fair value for Level 3 inputs have reconciliation requirements such as beginning and ending balances; separating changes for gains and losses; sales, issuances, and purchases; and transfers in and out of the category
4. Amount of total gains and losses attributable to unrealized gains and losses in #3 above
5. For annual valuations, the method used and discussion of changes in the models for the fair value analysis

Assets and liabilities valued on a non-recurring basis (i.e. impairment studies), disclosure must include information similar to the items listed in 1-5 above. In addition, where fair value measurements rely heavily on Level 3 inputs, a discussion of the assumptions and models must be included.

Besides the guidance provided by FAS 157, the SEC has required certain public filers in the media industry to greatly expand their disclosure statements. The SEC comments have focused on expanded descriptions of important variables and the sensitivity of the valuation models to changes in these key variables.

Practical Application

Although SFAS 157 improves the consistency in the application of valuation measurement techniques and prioritizes the type of model assumptions employed by valuation practitioners, practical application of the statement is still challenging for those assets and liabilities where there is a thin or no market. For example, the valuation of most intangible assets, either as part of an acquisition or in impairment analyses, requires a significant amount of judgment. Directly comparable assets are rarely bought or sold in open markets where the nature of the assets and the terms of the transactions are publicly disclosed.

This challenge is particularly evident within the Media and Entertainment industry where a significant part of the value of the business is based upon intangible assets. These intangible assets may include programming/content agreements, customer/subscriber lists, advertiser contracts and relationships, employment/talent contracts, FCC licenses, franchise agreements, mastheads, royalty agreements, copyrights, and the like. Many of these intangible assets are unique to a particular market or business, do not trade freely, and are difficult to quantify.

In addition, as the Media and Entertainment industry has consolidated, it is important to take into account the synergies that might be available to market participants. Questions to consider may include

- Is there any overlap of existing subscribers or advertisers within an acquired customer or subscriber base?
- Does the additional FCC license acquired in the marketplace enhance the acquirer's existing portfolio of stations? Is there an overlap of signal coverage between the acquired license and currently owned licenses?
- How does the potential programming or content affect an entertainment company's existing audience base?

According to the Statement, fair value refers to "...the use of an asset that would maximize the value of the asset or the group of assets in which the asset would be used by market participants."⁶ With such a definition, the value of the asset might

⁶ Original Pronouncements As Amended, SFAS 157, *Fair Value Measurements*, Appendix A, FAS157-14.

be quite different if an intangible asset such as a brand or software IP is acquired by a strategic or financial buyer. Certain strategic buyers may be able to use synergies within their existing group of assets to provide incremental value to the acquired asset. A financial group may purchase the asset on a stand-alone basis, not able to enhance the value of the asset with its particular existing operations. Alternatively, because of competitive circumstances, the asset may have more value to an outsider (financial buyer) than it does to an existing owner of similar assets. Care must be taken in considering typical market participants and what the alternative uses are for the assets in question.

SFAS 157 requires the valuation practitioner to consider multiple valuation techniques where appropriate. Depending upon the facts, a single method may provide the most reasonable fair value or the process may require weighting the results of several techniques. For example, the valuation of an intangible asset such as a customer list could be analyzed based upon all three approaches to value. The market approach would evaluate the market price based upon what comparable customer lists might trade for. Mostly likely, such lists would be comprised of a Level 2 input as a valuation multiple (value per customer, value per subscriber, value per advertiser) based upon similar observable transactions. The cost approach would examine the value of the customer list from the perspective of what it would cost a market participant to develop a comparable list of customers from the ground up. An income approach would measure the incremental cash flow that the customer list could generate over the life of the asset. Given the hierarchy of inputs indentified by SFAS 157, each approach might be weighted by the type of input and adjusted for other significant factors to determine the fair value of the customer list to a typical market participant.

The valuation of liabilities poses another challenge under the definition of fair value. In many cases, liabilities are not as freely traded as assets. In addition, the market for debt, potential lawsuits, or future contingencies may be even more uncertain. In FSP FAS 157-f, *Measuring Liabilities under FASB Statement No. 157*, guidance is provided on the measurement of liabilities. The value of the liability should represent a Level 1 value if possible. If there is no ready market, the valuation technique should attempt to make use of observable inputs.

For example, if traded as an asset, one might consider the quoted price of an identical or comparable liability traded as an asset in an active or inactive market. Adjustments to these prices may be required to reflect factors that are different in the asset traded price versus the liability under analysis. FSP FAS 157-f also states that any contractual restriction that is part of a quoted price for an identical liability is already taken into consideration in the price and no adjustment would be warranted.

Conclusion

SFAS 157 improves the consistency and transparency of fair market valuation under GAAP by providing a framework and guidance for the valuation of assets and liabilities for financial reporting. Further clarification and improvements will be necessary and many are already underway. Many assets (particularly intangible assets) and liabilities do not have quoted prices from an orderly market (Level 1 inputs) or even comparable transaction multiples (Level 2 inputs). Unique assets and liabilities, with unobservable inputs, will continue to challenge valuation professionals and financial executives.