Chapter 1

Concepts and Application of Financial Accounting Standards Board Accounting Standards Codification 820

1.01 Financial Accounting Standards Board (*FASB*)[1] *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, defines *fair value* and establishes a framework for measuring fair value for financial reporting purposes. This chapter provides an overview of the concepts and framework of FASB ASC 820 and is intended to provide background for discussions included in chapter 2, "Accounting Considerations When Testing Goodwill for Impairment;" chapter 3, "Qualitative Assessment;" and chapter 4, "Measuring Fair Value of a Reporting Unit," of this guide. The sections "Applying FASB ASC 820 Valuation Techniques to Reporting Units" and "Applying FASB ASC 820 Framework to Reporting Units" in this chapter provide a more specific discussion of the requirements of FASB ASC 820 as it pertains to measuring the fair value of a *reporting unit* for *goodwill impairment* testing.

General Concepts of FASB ASC 820

1.02 As stated in FASB ASC 820-10-05-1B

> [f]air value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same—to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

1.03 FASB ASC 820-10-05-1C further explains that

> [w]hen a price for an identical asset or liability is not observable, a reporting entity measures fair value using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, a reporting entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value.

[1] Words or terms defined in the glossary are set in italicized type the first time they appear in the body of this guide.

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1.04 FASB ASC 820 codifies a number of fair value concepts, representing the framework for fair value measurement in financial reporting. These concepts include the following:

- *Fair value definition.* Under FASB ASC 820, fair value is defined as "[t]he 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." Under this definition, fair value is an exit price from a *market participant* perspective.
- *The asset or liability.* According to paragraphs 2B–2E of FASB ASC 820-10-35

> **35-2B** A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value a reporting entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:
>
> *a.* The condition and location of the asset
>
> *b.* Restrictions, if any, on the sale or use of the asset.
>
> **35-2C** The effect on the measurement arising from a particular characteristic will differ depending on how that characteristic would be taken into account by market participants....
>
> **35-2D** The asset or liability measured at fair value might be either of the following:
>
> *a.* A standalone asset or liability (for example, a financial instrument or a nonfinancial asset)
>
> *b.* A group of assets, a group of liabilities, or a group of assets and liabilities (for example, a reporting unit or a business).
>
> **35-2E** Whether the asset or liability is a standalone asset or liability, a group of assets, a group of liabilities, or a group of assets and liabilities for recognition or disclosure purposes depends on its unit of account. The unit of account for the asset or liability shall be determined in accordance with the Topic that requires or permits the fair value measurement, except as provided in this Topic [FASB ASC 820].

- *The transaction.* Paragraphs 3 and 5 of FASB ASC 820-10-35 state

> **35-3** A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.
>
> **35-5** A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:
>
> *a.* In the principal market for the asset or liability
>
> *b.* In the absence of a principal market, in the most advantageous market for the asset or liability.

Paragraphs 5A–6C of FASB ASC 820-10-35 provide further discussion on identifying the principal (or most advantageous) markets.

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- *Market participants.* FASB ASC 820-10-35-9 provides that

  > [a] reporting entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest. In developing those assumptions, a reporting entity need not identify specific market participants. Rather, the reporting entity shall identify characteristics that distinguish market participants generally, considering factors specific to all of the following:
  >
  > *a.* The asset or liability
  >
  > *b.* The principal (or most advantageous) market for the asset or liability
  >
  > *c.* Market participants with whom the reporting entity would enter into a transaction in that market.

- *The price.* According to FASB ASC 820-10-35-9A

  > [f]air value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

- *Valuation techniques.*[2] As stated in FASB ASC 820-10-35-24A

  > [t]he objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. Three widely used valuation techniques are the market approach, cost approach, and income approach. The main aspects of those approaches are summarized in paragraphs 820-10-55-3A through 55-3G. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.

- *Fair value hierarchy.* As indicated in FASB ASC 820-10-35-37

  > [t]o increase consistency and comparability in fair value measurements and related disclosures, this Topic [FASB ASC 820] establishes a fair value hierarchy that categorizes into three levels ... the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to

[2] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, refers to valuation approaches and valuation techniques. However, Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, VS sec. 100), refers to valuation approaches and methods (not techniques). SSVS No. 1 defines *valuation method* as, within approaches, a specific way to determine value. This definition is consistent with the meaning attributed to valuation techniques in FASB ASC 820. Also, in practice, many valuation techniques are referred to as methods (for example, guideline public company method, guideline company transactions method, and discounted cash flow method). As a result, this guide uses the terms *technique* and *method* interchangeably to refer to a specific way of determining value within an approach.

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quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

1.05 FASB ASC 820 also codifies a number of fair value concepts as it relates to nonfinancial assets, as follows:

- *Highest and best use.* Paragraphs 10A-10C of FASB ASC 820-10-35 indicate that

  > **35-10A** A fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.
  >
  > **35-10B** The highest and best use of a nonfinancial asset takes into account the use of the asset that is physically possible, legally permissible, and financially feasible...
  >
  > **35-10C** Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

- *Valuation premise for nonfinancial assets.* FASB ASC 820-10-35-10E states

  > The highest and best use of a nonfinancial asset establishes the valuation premise used to measure the fair value of the asset, as follows:
  >
  > *a.* The highest and best use of a nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business).
  >
  > 1. If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (that is, its complementary assets and the associated liabilities) would be available to market participants.
  > 2. Liabilities associated with the asset and with the complementary assets include liabilities that fund working capital, but do not include liabilities used to fund assets other than those within the group of assets.
  > 3. Assumptions about the highest and best use of a nonfinancial asset shall be consistent for all of the assets (for which highest and best use is relevant)

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of the group of assets or the group of assets and liabilities within which the asset would be used.

b. The highest and best use of a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use of the asset is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis.

As indicated in FASB ASC 820-10-35-11A

> [t]he fair value measurement of a nonfinancial asset assumes that the asset is sold consistent with the unit of account specified in other Topics (which may be an individual asset). That is the case even when that fair value measurement assumes that the highest and best use of the asset is to use it in combination with other assets or with other assets and liabilities because a fair value measurement assumes that the market participant already holds the complementary assets and associated liabilities.

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Applying FASB ASC 820 Valuation Techniques to Reporting Units

1.06 As indicated in paragraph .04 of the AICPA's Statement on Standards for Valuation Services (*SSVS*) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, VS sec. 100), in the process of estimating value, the *valuation specialist* applies valuation approaches and valuation methods and uses professional judgment. The use of professional judgment is an essential component of estimating value. Also, it is important for the valuation specialist to consider facts and circumstances specific to the reporting unit being valued.

1.07 The fair value of a reporting unit is the price that would be received to sell the reporting unit as a whole in an orderly transaction between market participants at the measurement date. Valuation approaches used to measure the fair value of a reporting unit may be classified broadly as income, market, and asset.[3] FASB ASC 820-10-35-24 states that "[a] reporting entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs." Therefore, when valuing a reporting unit for goodwill impairment testing purposes, all three approaches should be considered and the approach or approaches that are appropriate under the circumstances should be selected.

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[3] FASB ASC 820 describes three valuation approaches—income, market, and cost. The concepts underlying these approaches apply broadly to the valuation of discrete assets and business entities. Within FASB's cost approach concept, practitioners distinguish valuations of individual assets and business entities by using different terminology. The cost approach is said to have been applied when valuing individual assets, and the asset approach is said to have been applied when valuing business entities. The *International Glossary of Business Valuation Terms*, which has been adopted by a number of professional societies and organizations, including the AICPA, and is included in appendix B of SSVS No. 1, defines *asset approach* as a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities. This guide addresses valuation of reporting units. As a result, this guide focuses on the three approaches that can be used to value a reporting unit (income, market, and asset).

1.08 Each of the three approaches can be used to measure fair value of a reporting unit for goodwill impairment testing. As provided in FASB ASC 820-10-35-24B

> [i]n some cases, a single valuation technique will be appropriate.... In other cases, multiple valuation techniques will be appropriate (for example, that might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (that is, respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

Income Approach

1.09 As stated in FASB ASC 820-10-55-3F, "[t]he income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts." The *income approach* obtains its conceptual support from its basic assumption that value emanates from expectations of future income and cash flows.

1.10 The income approach may be used to estimate the fair value of the reporting unit. Whereas the *market approach* is based on market data which may need to be adjusted for any differences between the selected comparable entities and the subject reporting unit, the income approach is often based on *unobservable inputs*. As stated in FASB ASC 820-10-35-54A

> [a] reporting entity shall develop unobservable inputs using the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, a reporting entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the reporting entity that is not available to other market participants (for example, an entity-specific synergy).

1.11 The valuation technique commonly used in applying the income approach to value a reporting unit is the *discounted cash flow (DCF) method*. The DCF method requires estimating future economic benefits and applying a market participant *discount rate* to equate them to a single present value. The future economic benefits to be discounted are generally a stream of periodic cash flows attributable to the asset being valued[4] over a discrete period, followed by the application of a *terminal value* at the end of the discrete period. However, future economic benefits could take other forms under specific circumstances (for example, a lump sum payment at a particular time in the future without any interim cash flows). There are many considerations in applying the income approach. A detailed discussion and an illustration of the DCF method are included in paragraphs 4.21–.42, 4.86–.87, and schedules 4.1–4.9 of the "Comprehensive Example" section.

[4] The asset being valued could be a single asset, a collection of assets, or an entire entity.

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Market Approach

1.12 As stated in FASB ASC 820-10-55-3A, "[t]he market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business." The market approach bases the fair value measurement on what other similar entities or comparable transactions indicate the value to be.

1.13 The market approach can be used to value a reporting unit provided that appropriate market data can be identified. The market approach bases the fair value measurement on the information obtained from observed trading prices and transaction terms of comparable entities, comparing and contrasting their characteristics and using information from the observed prices of the comparable entities to benchmark the fair value measurement.

1.14 Two commonly used valuation techniques for measuring the fair value of a reporting unit under the market approach are the *guideline public company method* and the *guideline company transactions method*. The guideline public company method compares pricing metrics based on the stock prices of public companies to the subject reporting unit. These pricing metrics, such as price-to-revenues or price-to-earnings before interest, taxes, depreciation, and amortization (*EBITDA*), are calculated for each public company. These metrics are then analyzed, adjusted if appropriate, and applied to the subject reporting unit's figures. The guideline company transactions method is similar, but it uses recent merger and acquisition transaction data for acquisitions of target companies that are similar to the subject reporting unit.

1.15 The ability to apply a market approach may be limited by the availability of guideline publicly traded entities and market data for comparable transactions. However, even if a market approach is deemed to be appropriate because suitable data is available, adjustments to the market multiples are normally necessary to reflect the differences in the level of comparability between the guideline entities and the subject reporting unit. *Control premiums*[5,6] may also need to be considered.

1.16 A detailed discussion and an illustration of the guideline public company method are included in paragraphs 4.44–.72, 4.88, and schedules 4.10–4.10.2 of the "Comprehensive Example" section. A detailed discussion and an illustration of the guideline company transactions method are included in paragraphs 4.73–.83, 4.89, and schedules 4.11–4.11.1 of the "Comprehensive Example" section.

Asset Approach

1.17 The *International Glossary of Business Valuation Terms*, which has been adopted by a number of professional societies and organizations, including the AICPA, and is included in appendix B of SSVS No. 1, defines the *asset approach* as "[a] general way of determining a value indication of a business,

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[5] As of the writing of this guide, the Appraisal Foundation is working on a project regarding the assessment and measurement of control premiums in valuations for financial reporting. The purpose of this project is to present views on how to approach and apply certain aspects of the valuation process appropriate for measuring the fair value of controlling interests in business enterprises for financial reporting purposes. Please refer to the Appraisal Foundation's website at www.appraisalfoundation.org for further information about this project and its status.

[6] Control premiums are also frequently referred to as acquisition premiums.

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business ownership interest, or security using one or more methods based on the value of the assets net of liabilities."

1.18 The asset approach is used in very limited situations for valuing a reporting unit. The application of the asset approach entails separate valuation of each asset and liability within the reporting unit. The fair value of the reporting unit is the sum of the fair values of its net assets. Each asset or liability within the reporting unit may be valued using a different valuation technique (that is, income, market, or *cost approach*) that is applicable to each asset or liability within the reporting unit. When using the asset approach, it is important to consider not only those assets that are recognized on the entity's financial statements but also assets that are not recognized on the financial statements. Examples of applying this approach to value a reporting unit may be when the reporting unit is a holding company that contains a joint venture investment and land or is an operating company with earnings that do not provide a sufficient return on assets.

Applying FASB ASC 820 Framework to Reporting Units

1.19 FASB ASC 820 provides a framework for measuring fair value and includes key concepts that should be applied when measuring the fair value of a reporting unit for purposes of the goodwill impairment test. The following process, which is described in paragraphs 1.20–.28, provides ways of obtaining information or making assumptions about required information when measuring the fair value of a reporting unit:

- Determine the unit of account
- Determine the valuation premise
- Identify the potential markets
- Determine market access
- Apply the appropriate valuation approaches
- Determine the fair value

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Determine the Unit of Account

1.20 The unit of account determines what is being measured by reference to the level at which the asset is aggregated or disaggregated based on U.S. generally accepted accounting principles requirements. According to FASB ASC 350, *Intangibles—Goodwill and Other*, the unit of account for goodwill impairment testing is the reporting unit.

Determine the Valuation Premise

1.21 The reporting unit's highest and best use establishes the valuation premise used to measure its fair value. After determining the unit of account, an entity should assess the highest and best use for the reporting unit based on the perspective of market participants. Entity-specific intentions are not considered in the measurement of fair value unless those assumptions are consistent with market participant views.

1.22 Entities need to consider whether the market participant would operate the reporting unit on a standalone basis or in combination with other assets or other reporting units. This decision will affect the fair value of the reporting unit. For example, if an entity assumes that a market participant would continue to operate the reporting unit on a standalone basis, the reporting unit would be valued as such. Adjustments for market participant synergies (when it is assumed that the market participant possesses assets that can be utilized by the reporting unit to enable it to either increase revenues with the same cost structure or realize lower costs on the same volume) or additional expenses for items unique to the operations of the reporting unit would need to be considered.

1.23 If the entity assumes that the market participant would operate the reporting unit in conjunction with other assets or with other reporting units in an ongoing business, these factors would be incorporated into the fair value measurement of each individual reporting unit. See example 4-1, "Incorporating Market Participant Assumptions in Prospective Financial Information."

Identify the Potential Markets

1.24 As indicated in FASB ASC 820-10-35-5A, "[a] reporting entity need not undertake an exhaustive search of all possible markets to identify the principal market or, in the absence of a principal market, the most advantageous market, but it shall take into account all information that is reasonably available." In order to identify the principal (or most advantageous) market, the entity would take into account the potential buyers likely to consider acquiring a controlling interest in the reporting unit at the time of goodwill impairment testing.

1.25 In making assumptions that may have an impact on the fair value of the reporting unit, it is helpful to consider the following factors when identifying the principal (or most advantageous) market:

a. Determine whether the potential market is active, inactive, or recently became inactive.

b. Identify the groups of potential market participants (for example, strategic or financial buyers) and within those broad categories, identify subgroups of potential market participants.

c. Assess the competitive nature of the market (for example, perfect competition or monopolistic).

Although these market factors may provide some pricing information, significant adjustments may need to be made when measuring the fair value of reporting units.

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Determine Market Access

1.26 Once an entity has identified the potential market(s) it should assess whether it has access to these potential markets. As stated in FASB ASC 820-10-35-6A, "the reporting entity must have access to the principal (or most advantageous) market at the measurement date." As a result, management should identify the characteristics of potential market participants and principal (or most advantageous) market(s) when measuring fair value.

Apply the Appropriate Valuation Approaches

1.27 Next, an entity would need to apply the appropriate valuation technique. As discussed in paragraph 1.07, when measuring the fair value of a reporting unit the income, market, and asset approaches would be considered and the approach or approaches that are appropriate under the circumstances should be selected. Under each approach, various valuation techniques can be used to measure fair value, and entities may need to consider multiple valuation techniques. In some cases, the fair value measurements related to reporting units will require a greater level of judgment and subjectivity due to the lack of existing markets and observable inputs. Entities would need to document the key assumptions made and techniques used when measuring the fair value of a reporting unit.

Determine the Fair Value

1.28 Lastly, the entity should assess the results of the various valuation techniques used and arrive at a fair value measurement for a reporting unit. The determination of fair value will require judgment. See chapter 4 for an illustration of how to determine the fair value measurement of a reporting unit to be used for goodwill impairment testing when both the income and the market approaches are used.

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