

Technical Line

Technical guidance on standards
and practice issues

Fair value considerations – Statement 157

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Introduction

In September 2006, the Financial Accounting Standards Board (FASB or the Board) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (Statement 157). Statement 157 establishes a framework for measuring fair value under US generally accepted accounting principles (GAAP), provides a single definition of fair value within that framework, and expands disclosures about the use of fair value measurements.

Statement 157 became effective for fiscal years beginning after 15 November 2007, however, delayed adoption was permitted for nonrecurring, nonfinancial assets and liabilities until fiscal years beginning after 15 November 2008 (1 January 2009 for calendar year entities).

The adoption of Statement 157 related to the measurement of financial instruments proved to be a challenge for many reporting entities as the concepts and principles introduced or clarified in the standard often necessitated the need for a rigorous review of historical valuation practices. The difficulty in applying this standard has been exacerbated by the current market environment and a decrease in the availability or transparency of certain market observable data. While the valuation of nonfinancial assets and liabilities has historically been less dependent on market observable data than financial instruments, current market conditions will likely pose additional challenges in the measurement of these items as well.

Readers should also recall that the primary reason certain preparers and other constituents sought a deferral of the effective date of Statement 157 for nonfinancial assets and liabilities was due to implementation issues associated with the heavy reliance on unobservable inputs in estimating their fair values. Many of these concerns remain as the FASB, the FASB's Valuation Resource Group, the SEC

and others have focused much of their attention on the issues surrounding the application of Statement 157 to financial instruments in inactive markets.

Notwithstanding these concerns, the broad principles regarding the fair value measurement of nonfinancial items remain relatively unchanged from those that previously existed. The framework provided in FASB's Statement of Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (Concepts Statement 7) addressed the use of future cash flows and present value techniques as a basis for accounting measurements, including fair value. Entities are often required to use estimates of expected future cash flows in accounting measurements when there are no observable transactions for similar assets and liabilities, as is often the case with many nonfinancial assets and liabilities. Statement 157 did not significantly amend the principles espoused in Concepts Statement 7 but rather incorporated and clarified the guidance in Concepts Statement 7 for using present value techniques to estimate fair value, elevating much of this guidance to "Level A" GAAP. While the guidance in Concepts Statement 7 is fairly robust, it was primarily limited to the application of one valuation technique (the income approach), whereas Statement 157 provides a broad framework for fair value measurements determined using the income, market and/or cost approach.

The primary objective of Statement 157 is to increase consistency, comparability and transparency of the fair value measurements utilized in financial reporting by requiring the use of a singular definition of fair value (and a framework in which to apply that definition) across GAAP. With limited exceptions,¹ the guidance in Statement 157 applies to all existing pronouncements under GAAP that require (or permit) the use of fair value measurements. Given the broad use of fair value measurements in the accounting literature, the principles in Statement 157 will be applied to many different types of assets and liabilities with various fair value accounting requirements (e.g., initial measurement, subsequent measurement, impairment). Because fair value measurement guidance had historically been included, in varying levels of detail, within the individual pronouncement that required (or permitted) the measurement, diversity in practice in estimating fair values existed across asset or liabilities type. Accordingly, changes to current practice upon

the adoption of Statement 157 may vary by entity, asset or liability type, or accounting pronouncement (i.e., the reason for the fair value measurement such as impairment vs. initial recognition). In some situations, the effect may be a fine-tuning or slight modification of certain assumptions utilized in an existing valuation methodology. While in other instances, the effect may be more significant.

While clarifying the objective of a fair value measurement for financial reporting purposes, Statement 157 does not expand the use of fair value measurements within GAAP. For example, an asset or liability measured at fair value on a non-recurring basis is not automatically adjusted in conjunction with the effective date of Statement 157. Instead, the principles of Statement 157 would be used in the next fair value measurement. However, the use of fair value measurements has been expanded under certain new FASB statements such as Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* (Statement 141(R)), which requires most assets acquired and liabilities assumed in a business combination to be initially measured at their fair value. The application of Statement 157 to items that were not previously measured at fair value could result in additional implementation challenges.

The purpose of this Technical Line is to highlight key changes in practice that are likely to occur when applying the fair value principles in Statement 157 to certain nonfinancial assets and liabilities and in limited instances, financial assets and liabilities. It should be noted that the FASB has recently issued for comment proposed FSP FAS 157-f, *Measuring Liabilities under FASB Statement No. 157*. Refer to our Hot Topic, *FASB issues proposal on measurement of liabilities at fair value*, for additional discussion of proposed FSP FAS 157-f. This Technical Line is also intended to provide a reminder as to certain measurement considerations related to financial assets and liabilities. We anticipate this publication to be read in conjunction with prior guidance issued related to Statement 157, including our Financial Reporting Developments publication *Fair Value Measurements – FASB Statement 157*, our technical line publication *FAS 142 impairment testing subsequent to the adoption of FAS 141(R), 157, and 160* dated 03 April 2009, and our various publications related to fair value measurements in specific industries including real estate, insurance, banking, hedge funds and private equity.

¹ For example, SFAS 123(R), Share-Based Payment, and SFAS 13, Accounting for Leases.

Summary of Statement 157

Statement 157 is a principles-based standard that establishes a framework for measuring fair value in GAAP. The Statement provides a singular definition of fair value within that framework and expands disclosures about the use of fair value measurements. The definition of fair value under Statement 157 is:

“[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.”

Although the definition in Statement 157 maintains the exchange price concept that existed in previous definitions of fair value, the revised definition (and its application in the fair value framework) provides clarity on a number of key considerations, including:

- ▶ Fair value is the price to sell an asset or transfer a liability and, therefore, represents an exit price, not an entry price.
- ▶ The exit price for an asset or liability is conceptually different from its transaction price (an entry price). While exit and entry price may be identical in many situations, the transaction price is no longer presumed to represent the fair value of an asset or liability on its initial recognition.
- ▶ Fair value is the exit price in the principal market (or, absent a principal market, the most advantageous market) in which the reporting entity would transact. The fair value measure should not be adjusted for transaction costs.
- ▶ Fair value is a market-based measurement, not an entity-specific measurement, and, as such, is determined based on the assumptions that market participants would use in pricing the asset or liability. In pricing an asset, market participants would consider the highest and best use of the asset (the use that would maximize the value of the asset), even if that use differs from the current use by the reporting entity.
- ▶ The exit price objective of a fair value measurement applies regardless of the reporting entity’s intent and/or ability to sell the asset or transfer the liability at the measurement date. Fair value is intended to represent an exit price in the current market, not the potential value of the asset or liability at some future date (e.g., the amount the reporting entity expects to realize on settlement or maturity).

- ▶ A fair value measurement should include an adjustment for risk if a market participant would include one in pricing the asset or liability, even if the adjustment is difficult to determine.

Certain of the important concepts highlighted within Statement 157 are discussed further below.

Exit price

Prior to the clarifying guidance contained in Statement 157, GAAP was not explicit regarding whether fair value represented an exit price or an entry price. While the exchange price concept in previous definitions of fair value was not determinative, there was a rebuttable presumption in GAAP that the transaction price represented the fair value of an asset or liability on its initial recognition. Statement 157 acknowledges that in many situations, transaction price will equal exit price and, therefore, represents fair value at initial recognition, but it does not presume this to be the case. The exit price concept inherently places additional focus on market participants’ assumptions, as the reporting entity is no longer deemed a party to the hypothetical exit transaction. Additional complexity could arise in situations where exit and entry markets differ or when multiple exit markets exist for an asset and the principal market must be determined.

Highest and best use

Highest and best use is a valuation concept that establishes the premise of value based on the use of an asset by market participants that would maximize the benefit, or value, of the asset or the group of assets to market participants. The highest and best use of the asset will establish either an “in-use” or an “in-exchange” premise of value. If the asset provides maximum benefit when used in combination with other assets, or as an asset group, then the premise is in-use. If the maximum benefit from the asset is on a standalone basis, then the valuation premise is in-exchange. Under either valuation premise (i.e., in-use or in-exchange), fair value is measured as the exit price in a hypothetical transaction.

While the concept of highest and best use is an established valuation principle, it represents a new concept in the accounting literature. As such, the application of Statement 157 may result in changes to existing practice when the reporting entity’s intended use of the asset might not be the highest and best use of the asset. Even if the intended use by

the reporting entity is the same as the highest and best use of the asset or asset group, the underlying assumptions used to estimate the fair value the asset(s) should consider market participant assumptions, not entity-specific assumptions. Anticipated synergies (i.e., the ability of the buyer to use the asset with other assets to maximize value) from market participants should be considered in the determination of the highest and best use of an asset. Entity-specific synergies, if they would differ from market participant synergies, should not be considered in the determination of highest and best use.

While the market participant focus in estimating fair value is not new to GAAP, the concepts of exit price and highest and best use within Statement 157 served to distinguish fair value from investment value or other entity-specific measures.

Risk premiums

Because fair value is a market-based measurement, not an entity-specific measurement, it should reflect all the assumptions that market participants would use in pricing an asset or liability, including assumptions about risk. Although Concepts Statement 7 (in the context of a present value technique as a basis for determining fair value) noted that “an estimate of fair value should include the price that market participants would receive for bearing the uncertainties in cash flows”, an adjustment for risk was limited to circumstances where the amount of the risk adjustment was identifiable, measurable, and significant. Statement 157, however, requires the inclusion of a risk adjustment in measuring fair value if a market participant would include one in pricing the asset or liability, even if the adjustment is difficult to determine. The exclusion of a risk premium when a market participant would assume one results in a measure that does not faithfully represent fair value. As such, the degree of difficulty in determining a risk adjustment is not a basis to exclude an adjustment from the determination of fair value under Statement 157.

Valuation techniques

Statement 157 recognizes three valuation techniques to measure fair value: the market approach, income approach, and cost approach. The three approaches described in the Statement are consistent with generally accepted valuation methodologies utilized outside financial reporting.

While not all three approaches will be applicable for many assets or liabilities, Statement 157 notes that a reporting entity should measure the fair value of an asset or liability using all valuation techniques that are appropriate in the circumstances and for which adequate data are available. In those instances where appropriate, the use of multiple valuation techniques may represent a change in practice for entities that may have historically only utilized one valuation technique (e.g., an income approach using discounted cash flows).

It should also be noted that Statement 157 does not prioritize the use of one valuation technique over another, but rather prioritizes the use of observable inputs over unobservable inputs when applying those valuation techniques. The selection of the valuation method(s) to apply should consider the nature of the asset or liability being valued.

In the remainder of this document, we will discuss how the application of these and other principles in Statement 157 may affect the measurement of fair value as required by various pronouncements within GAAP.

Business combinations

Statement 141(R) requires that identifiable tangible and intangible assets acquired, liabilities assumed and any noncontrolling interest in the acquiree be recognized and measured as of the acquisition date at fair value (with certain limited exceptions). The FASB observed that to fairly represent economic circumstances at the acquisition date, in principle, all assets acquired and liabilities assumed should be recognized at the acquisition date and measured at fair value. As a result, Statement 141(R) expanded the use of fair value measurements under GAAP, thereby requiring many of the assets acquired and liabilities assumed in a business combination to be recorded at fair value in accordance with Statement 157. Attachment A to this article summarizes certain fair value considerations related to the valuation of assets acquired and liabilities assumed in a business combination.

For further details on Business Combinations under Statement 141(R) and the related determination of fair value of assets acquired or liabilities assumed please see our Financial Reporting Developments publication *FASB Statement No. 141(R), Business Combinations*.

Goodwill impairment

FASB Statement No. 142, *Goodwill and Other Intangible Assets* (Statement 142), was amended by Statement 141(R), Statement 157 and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* (Statement 160). As a result, any goodwill or other intangible asset impairment testing subsequent to the adoption of these statements will require that fair value be determined in accordance with the measurement principles of Statement 157. For step one of a goodwill impairment test, the fair value of a reporting unit will need to be determined in accordance with Statement 157. If step two of the goodwill impairment test is required, the underlying fair value of assets and liabilities of the reporting unit must also be determined in accordance with Statement 157. In addition, the measurement and recognition guidance in Statement 141(R) must be applied in order to determine the value of implied goodwill.

Attachment A to this article summarizes certain fair value considerations related to the valuation of assets acquired and liabilities assumed in a business combination and is equally applicable to step two of a goodwill impairment test. See our technical line publication on FAS 142 impairment testing dated 03 April 2009 for further discussion.

Long-lived assets

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (Statement 144), applies to recognized long-lived assets (or asset groups) of a business enterprise and not-for-profit organizations to be held and used or to be disposed of. Statement 144 contains two recognition and measurement models—one for assets to be held and used and one for assets held for sale.

See our Financial Reporting Developments publication, *Accounting for the Impairment or Disposal of Long-Lived Assets – FASB Statement 144*, for further discussion.

Assets to be held and used

The following is the three-step impairment model for assets to be held and used:

- ▶ Consider whether indicators of impairment are present.

- ▶ If indicators of impairment are present, determine whether the sum of the estimated undiscounted future cash flows attributable to the long-lived asset (group) in question is less than its carrying amount (the “recoverability” test).
- ▶ If less, recognize an impairment loss based on the excess of the carrying amount of the long-lived asset (group) over its respective fair value.

It is only in the third step above that Statement 157 is applicable. When an asset (group) that is held and used is not recoverable, it is recognized and measured at the lower of its carrying amount or fair value in accordance with Statement 157. When an impairment loss is recognized, the impaired value of the asset becomes its new carrying amount. These assets are not subsequently remeasured at fair value unless indicators of further impairment arise in a subsequent period and the asset (group) again does not pass the recoverability test. Accordingly, assets held and used under Statement 144 are measured at fair value on a nonrecurring basis. This distinction is important because assets and liabilities that are measured at fair value on a recurring basis are subject to different disclosures under Statement 157.

For purposes of recognition and measurement of an impairment loss, a long-lived asset should be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Therefore, asset groups may include assets and liabilities outside the scope of Statement 144 (e.g., goodwill—if certain conditions are met, inventory, receivables and indefinite-lived intangible assets). If assets and or liabilities are grouped for purposes of a test for recoverability, they are referred to as an “asset group.”

Fair value is used in two key determinations under Statement 144 for held and used assets. The first, as noted previously, is to determine the amount of impairment by determining the fair value of the long-lived asset (group). The second is in the allocation of any impairment loss of an asset group to the related long-lived assets. The impairment loss reduces the carrying amount of the long-lived assets within the scope of Statement 144 in an asset group, on a pro-rata basis using the relative carrying amounts of those assets. However, the carrying amount of a long-lived asset of the group is not reduced below its fair value, if determinable.

Assets held for sale

Under Statement 144, a long-lived asset (or disposal group) to be disposed of by sale should be considered “held for sale” when all of the following criteria for a qualifying plan of sale are met:

- ▶ Management, having the authority to approve the action, commits to a plan to sell the asset or disposal group.
- ▶ The asset or disposal group is available for immediate sale (i.e., a seller currently has the intent and ability to transfer the asset (group) to a buyer) in its present condition, subject only to conditions that are usual and customary for sales of such assets or disposal groups.
- ▶ An active program to locate a buyer, and other actions required to complete the plan to sell have been initiated.
- ▶ The sale of the asset or disposal group is probable (i.e., likely to occur), and the transfer is expected to qualify for recognition as a completed sale within one year, with several exceptions.
- ▶ The long-lived asset or disposal group is being actively marketed for sale at a price that is reasonable in relation to its current fair value.
- ▶ Actions necessary to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Assets held for sale are initially measured at the lower of carrying amount or “fair value less cost to sell.” A loss should be recognized for any initial adjustment of the long-lived asset’s or disposal group’s carrying amount to its fair value less cost to sell in the period the held for sale criteria are met. The fair value less cost to sell of the long-lived asset (disposal group) should be assessed each reporting period it remains classified as held for sale. Subsequent changes in the long-lived asset’s fair value less cost to sell (increase or decrease) would be reported as an adjustment to its carrying amount, except that the adjusted carrying amount should not exceed the carrying amount of the long-lived asset at the time it was initially classified as held for sale. A long-lived asset or long-lived assets within a disposal group should not be depreciated or amortized when classified as held for sale. The carrying amount of any asset that is not covered by Statement 144, including goodwill, that is included in a disposal group

classified as held for sale, should be adjusted in accordance with applicable generally accepted accounting principles (e.g., inventory in accordance with ARB 43 or goodwill in accordance with Statement 142).

Key considerations under Statement 157

Statement 144 incorporated the measurement principles of Concepts Statement 7 in discussing the use of a present value technique to determine fair value. Because of the similarities between Concepts Statement 7 and Statement 157, a Company that had previously developed a robust model for estimating fair value under a Concepts Statement 7 approach is less likely to experience a significant effect of adoption of Statement 157 in this area. That being said, certain elements of Statement 157 do warrant specific focus including:

- ▶ The cash flows used in the recovery test versus those used to determine fair value.
- ▶ The unit of valuation as compared to the unit of account.
- ▶ The effect of a sales contract on fair value for assets held for sale.
- ▶ The concept of “fair value less cost to sell” under Statement 157.
- ▶ Considerations in assessing appraisals.

Cash flows used in recoverability test versus those used to determine fair value

If indicators of impairment exist for an asset (group) to be held and used, an entity determines whether the sum of the estimated undiscounted future cash flows attributable to the asset (group) in question is less than its carrying amount. If those undiscounted cash flows are less than the carrying amount, then an entity will recognize an impairment loss based on the excess of the carrying amount of the asset (group) over its respective fair value. Statement 144 specifies that the cash flow estimates used in the recoverability test (Step 2) be based on entity-specific assumptions:

“Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity’s own assumptions about its use of the asset (asset group) and shall consider all available evidence. The assumptions used in developing those

estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others.”²

However, consistent with Concepts Statement 7, under Statement 157 cash flows used to determine fair value (using a present value technique) when determining the impairment loss (Step 3) must include assumptions that marketplace participants would use in their estimates of fair value. As a result, entities are not able to simply apply a discount rate to the cash flows used in Step 2 to determine fair value. There are several reasons why entity-specific and market participant assumptions may differ, including, but not limited to:

- ▶ The entity’s managers might intend different use or settlement than that anticipated by others. For example, they might intend to operate a property as a bowling alley, even though others in the marketplace consider its highest and best use to be a parking lot.
- ▶ The entity might hold special preferences, such as tax or zoning variances, not available to others.
- ▶ The entity might hold information, trade secrets or processes that allow it to realize (or avoid paying) cash flows that differ from others’ expectations.
- ▶ The entity might be able to realize or pay amounts through use of internal resources. For example, an entity that manufactures materials used in particular processes acquires those materials at cost, rather than the market price charged to others. An entity that chooses to satisfy a liability with internal resources may avoid the markup or anticipated profit charged by outside contractors.³

Unit of valuation and unit of account

Under Statement 144, the unit of account for assets to be held and used is a long-lived asset or assets grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.⁴ The unit of account is the basis for the recognition and measurement of an

impairment loss. Any impairment loss is allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the carrying amount of an individual long-lived asset cannot be reduced below its fair value. The carrying amounts of any other assets and liabilities not covered under Statement 144 (other than goodwill) that are included in an asset group should be adjusted in accordance with other applicable generally accepted accounting principles before the asset group is evaluated under Statement 144. After an entity has applied Statement 144, goodwill should be evaluated under Statement 142.

Statement 157 specifies that the “unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements,”⁵ but the unit of valuation need not be the unit of account. For example, the valuation premise may indicate that the unit of account and the unit of valuation may differ as discussed in Statement 157, footnote 8:

“The fair value of an asset in-use is determined based on the use of the asset together with other assets as a group (consistent with its highest and best use from the perspective of market participants), even if the asset that is the subject of the measurement is aggregated (or disaggregated) at a different level for purposes of applying other accounting pronouncements.”

If an entity determines that the unit of valuation is at a higher level than the unit of account (the asset group) for assets held and used under Statement 144 (i.e., the unit of valuation includes more of the entity’s assets and liabilities than the asset group), we believe that the entity should reconsider the asset group and unit of valuation. That is, an entity should be able to reconcile why the determination of the asset group (i.e., the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities) is appropriate when it excludes assets that are included in the unit of valuation. While possible, we believe it will be rare that an entity concludes that the unit of valuation includes assets not in the asset group.

² Statement 144, paragraph 17.

³ Concepts Statement 7, paragraph 32.

⁴ Statement 144, paragraph 10.

⁵ Statement 157, paragraph 6.

Additionally, the consideration of the highest and best use of the asset (asset group) from the perspective of market participants could result in situations where the unit of valuation includes synergistic assets held by market participants and is therefore at a level that exceeds the entity's lowest level of identifiable cash flows.

Effect of a sales contract on fair value for assets held for sale

An entity measures assets held for sale (disposal group) under Statement 144 at the lesser of carrying amount (prior to designation as held for sale) or fair value, less cost to sell at each reporting date until it is eventually disposed of. In some situations, the entity may enter into a sales contract for the disposal group several periods before the transactions closes. When determining fair value in periods after the sales contract was entered into, but before the transactions closes, it is not clear how the sales contract should be considered in the measure of fair value for the disposal group. In many instances, the time between the date on which the sales contract was executed and the measurement date will be so brief that it is unlikely that the value will change significantly, however there may be exceptions. We believe that the sales contract is effectively a component of the asset group, such that changes in fair value of the asset group would, in many cases, be largely offset by changes in the fair value of the sales contract.

Fair value less costs to sell

As noted previously, assets held for sale are recorded at fair value less cost to sell. Under Statement 157, fair value specifically excludes transaction costs, so some may question whether Statement 157 changes this guidance under Statement 144. We do not believe that Statement 157 changes the measurement objective for assets held for sale. Statement 157 is clear that the timing and presentation of how transaction costs are accounted for is outside the scope of the Statement and is determined by other guidance. As such, Statement 157 did not amend the accounting for assets reported at their fair value less cost to sell. The "fair value less cost to sell" measurement objective consists of two separate components: (1) fair value and (2) cost to sell. The fair value component of this measurement should be determined in accordance with the principles of Statement 157 (i.e., exit price, market participants assumptions, etc.), and would include those costs that a willing buyer and willing seller would include in pricing the asset (i.e., the cash flows assumed in estimating

the terminal value of the asset). Transaction costs expected to be incurred by the seller, would be included in the estimate of costs to sell for purposes of applying Statement 144.

To illustrate this concept, assume Company X purchases real estate from Company Y for \$500. Included in that transacted fair value amount were certain costs that market participants consider in pricing the asset. Also assume that costs to sell, as defined in Statement 144 are \$15. Assuming there was no bargain purchase, if Company X were to consider the real estate held for sale immediately after acquiring it, the real estate's fair value presumably would be \$500. Under Statement 144, however, the real estate held for sale would be measured at \$485, i.e., fair value (\$500) less costs to sell (\$15).

Considerations in assessing appraisals

The *Uniform Standards of Professional Appraisal Practice* (USPAP) are the generally accepted standards for professional appraisal practice in North America in valuing real estate, personal property and businesses. Although certain of the concepts of Statement 157 may be similar to concepts in USPAP, an assessment of the appraisal should be performed to determine that the appraised value is an appropriate measure of fair value for financial reporting purposes (that is, the appraisal has been performed in accordance with the principles of Statement 157).

The use of a third-party valuation specialist does not reduce management's ultimate responsibility for the fair value measurements (and related disclosures) in the entity's financial statements. Management must understand the assumptions used in the valuations, including those performed in accordance with the USPAP, and determine whether the assumptions are consistent with the tenets of Statement 157. That is, management may determine that an adjustment to the valuation may be necessary to comply with the provisions of Statement 157. Further, this due diligence should enable management to assess the observability of the inputs for purposes of determining the level of the fair value measurement within the fair value hierarchy.

For example, traditional real estate appraisal procedures and reports may not anticipate or explicitly address the requirements of Statement 157. It is possible that an appraisal (whether prepared internally or externally) includes assumptions that are not consistent with the concept of an

exit price in a hypothetical transaction at the measurement date as contemplated by Statement 157. An appraisal utilized for financial reporting purposes should be evaluated to determine whether the appraisal process and report are consistent with the requirements of Statement 157. Such an evaluation would include, but is not limited to, whether:

- ▶ The principal or most advantageous market has been appropriately considered.
- ▶ Appropriate market participants (or characteristics of market participants) have been identified and the assumptions market participants would utilize in pricing the asset have been used.
- ▶ Adjustments to market data are (a) based on observable or unobservable inputs or (b) significant to the overall fair value measure.
- ▶ All appropriate valuation approaches and techniques have been utilized.

When multiple valuation techniques are used, the merits of each valuation technique and the underlying assumptions embedded in each of the techniques should be considered in evaluating and assessing the results.

For example, if an appraisal of an office building was performed in accordance with the USPAP, the appraiser should analyze the relevant legal, physical and economic factors to the extent necessary to support a conclusion as to the highest and best use of the building. The appraisal of the office building may incorporate market participant assumptions about the future state of the building, rather than the building's current condition at the measurement date. Expectations about future improvements or modifications to be made to the building may be considered in the appraisal, such as the renovation of the building or the conversion of the office building into condominiums. However, the objective of the fair value measurement is to value the asset in its current form (e.g., as an office building).

As such, while market data (or expected future cash flows) associated with a transformed asset could be considered in estimating fair value, these inputs would need to be adjusted for renovation or transformation costs (such as, legal, rezoning and remodeling costs) and the associated profits expected by a market participant in determining whether an

alternative use of the asset would maximize the value of the asset. Accordingly, management should evaluate whether transformation costs and any associated profits resulting from the transformation process have been included in the appraised value and if the inclusion of such amounts is appropriate.

Exit or disposal activities

FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (Statement 146), establishes an accounting model for certain costs associated with exit or disposal activities. Under this model, a liability for costs associated with an exit or disposal activity should be recognized and initially measured at fair value only when it is incurred. The FASB acknowledges in Statement 146 that a present value technique generally will be the best available valuation technique to estimate the fair value of a liability. As a result, most liabilities within the scope of Statement 146 have been measured using a present value technique as discussed in Concepts Statement 7. However, many of these measurements (consistent with the examples in Statement 146) did not include a market risk premium because it was either determined not to be significant or, as a practicability exception, because it was determined that a reliable estimate of the market risk premium could not be made (a permitted Concepts Statement 7 exception). As noted previously, a similar practicability exception does not exist under Statement 157. As a result, we expect much of the effort related to the implementation of Statement 157 related to the measurement of exit or disposal costs in the scope of Statement 146, to be focused on whether a risk premium is significant and if so how it should be determined. See our Financial Reporting Developments publication, *Accounting for Costs Associated with Exit or Disposal Activities – Statement 146*, for a further discussion of Statement 146.

While the initial measurement of liabilities accounted for under Statement 146 is at fair value, subsequent changes to the liability are measured using the credit-adjusted risk-free rate⁶ that was used to measure the liability initially (under a

⁶ The credit-adjusted risk-free rate is a discount rate that, while incorporating credit risk, presumes that other variability in cash flows is reflected by probability weighting projected outcomes. To the extent variability is not reflected in the probability-weighted outcomes, the discount rate would need to take into account such uncertainty and would no longer be a credit-adjusted risk-free rate.

present value technique). Accordingly, only the initial measurement of liabilities in the scope of Statement 146 is subject to Statement 157, because the subsequent measurement is not a fair value measurement. This distinction is important in that only assets and liabilities that are subsequently measured at fair value are subject to the additional disclosures required by Statement 157.

Costs covered by Statement 146 include, but are not limited to, the following: (1) involuntary termination benefits provided to employees that are involuntarily terminated under the terms of a one-time benefit arrangement that, in substance, is not an ongoing benefit arrangement or a deferred compensation contract; (2) certain contract termination costs, including operating lease termination costs; and (3) other costs associated with an exit or disposal activity.

Scope – leases

When Statement 157 was issued, certain concerns were raised regarding the application of Statement 157 to leases accounted for under FASB Statement No. 13, *Accounting for Leases* (Statement 13). Because of these concerns, the FASB issued FASB Staff Position FAS 157-1, “Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13” (FSP FAS 157-1). FSP FAS 157-1 amends Statement 157, to exclude Statement 13, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13. However, this scope exception does not apply to Statement 146 restructuring liabilities. Accordingly, lease termination costs that are subject to Statement 146 would be initially measured at fair value in accordance with the principles in Statement 157. See further discussion under “Contract termination costs, including operating leases”, below.

Contract termination costs, including operating leases

Under Statement 146, a liability for costs to terminate a contract before the end of its term is recognized either: (1) when an entity exercises its contractual right to terminate the contract in accordance with the contract terms (contract termination) or (2) when a liability exists for costs that will

continue to be incurred under a contract for its remaining term without economic benefit to the entity (referred to as a “cease-use date approach”). The resultant liability is measured at fair value. Factors to consider in applying Statement 157 in accounting for contract termination costs at fair value are discussed below.

Contractual right to terminate a contract

If a company exercises a contractual right to terminate a contract in accordance with the contract terms (e.g., exercises a previously existing buyout clause or negotiates a binding early termination), the resultant liability is required to be measured at fair value. Fair value is to be determined in accordance with Statement 157. One of the issues most commonly identified as a Statement 157 implementation issue, the consideration of a market risk premium, is generally not expected to be significant for such a liability. That is because both the amount and timing of the payment in such a case is generally certain and a market risk premium is designed to compensate for uncertainty as to the amount and timing of cash flows. The fair value of the liability should consider an adjustment for nonperformance risk and a profit margin demanded by a third party.

Cease-use date approach to contract termination

The fair value of a liability for a lease termination under a cease-use date approach is the present value of the obligation adjusted for valuation assumptions (e.g., market risk premium and profit margin) that reflect the amount a market participant would require to assume the obligation at the measurement date. In valuing a lease under the cease-use date approach, the fair value of the obligation should be determined based on the remaining lease rentals, adjusted for the effects of any prepaid or deferred items recognized, reduced by estimated sublease rentals that could be reasonably obtained, even if the entity does not intend to sublease (so long as it is contractually permitted). The measurement of any net liability would be a discounted amount that includes the nonperformance risk associated with the liability and an appropriate market risk premium. The effect, if any, of the market risk premium, will be relative to the uncertainty in the timing and amount of the future cash flows. Although the contractual lease payments are fixed with respect to both timing and amount, sublease income, if any, can fluctuate as to the timing of when a tenant would sublease and the amount of rent that would be paid. An operating lease

example is included in Appendix A to Statement 146, and it excludes a market risk premium. The example notes that a market risk premium was excluded as follows:

“Because the lease rentals are fixed by contract and the estimated sublease rentals are based on market prices for similar leased property for other entities having similar credit standing as the entity, there is little uncertainty in the amount and timing of the expected cash flows used in estimating fair value at the cease-use date and any risk premium would be insignificant. In other circumstances, a risk premium would be appropriate if it is significant.”

We believe the key point in this example is likely the final sentence. That is, a company will have to determine whether a market risk premium would be significant rather than simply excluding it.

Subsequent changes to contract termination costs due to the timing and amount of estimated cash flows should be measured using the credit-adjusted, risk-free rate that was used to measure the liability initially, which again is not a fair value measurement. Any resulting adjustment is recorded in the period of change. An example would be a property under an operating lease that an entity ceases to use and expects to obtain certain market based sublease income. In this case, the entity would record a liability (expense) for the future lease rentals at the cease-use date (reduced by reasonably obtainable sublease rentals, if any) and adjust the amount of the liability based upon sublease market changes prior to entering into a sublease and to actual sublease income if a sublease has been entered into.

Employee termination costs and other exit costs

Employee termination costs within the scope of Statement 146 represent a one-time benefit arrangement that is deemed to exist at the date the plan of termination meets certain criteria and has been communicated to employees. Employee termination costs that are not one-time benefit arrangements are not within the scope of Statement 146 and are subject to the measurement and recognition provisions of other standards that address the accounting for other employee benefits, including FASB Statements No. 87, *Employers’ Accounting for Pensions*, No. 88, *Employers’ Accounting for Settlements and Curtailments of Defined*

Benefit Pension Plans and for Termination Benefits, No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*, and No. 112, *Employers’ Accounting for Postemployment Benefits*. Employee termination costs within the scope of Statement 146 are initially measured at fair value, generally using a present value technique that incorporates valuation assumptions including the credit adjusted risk free rate. The timing and amount of liability recognition under Statement 146 are dependent on whether employees are required to render future service in order to receive the termination benefits. If employees are required to render service until they are terminated and that service period extends beyond a “minimum retention period,” the liability (expense) should be recognized ratably over the future service period, even if the benefit formula used to calculate the termination benefit is based on past service.

Because a liability for employee termination costs within the scope of Statement 146 must meet fairly rigid criteria to be recognized, little uncertainty generally exists with respect to the timing and amount of the future cash flows. Accordingly, the effect of certain valuation assumptions such as a market risk premium will likely be insignificant. This point was made by the FASB in the implementation guidance to Statement 146 that noted:

“In this case, a risk premium is not considered in the present value measurement. Because the amounts of the cash flows will be fixed and certain as of the termination date, marketplace participants would not demand a risk premium.”

Subsequent changes to employee termination costs due to the timing and amount of estimated cash flows should be measured using the credit-adjusted risk-free rate that was used to measure the liability initially. Any resulting adjustment is recorded in the period of change. Because this is not a fair value measurement, Statement 157 does not apply.

Asset retirement obligations (ARO)

FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (Statement 143), and FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (Interpretation 47), apply to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset. For the purposes of Statement 143, a legal obligation is an obligation that a party

is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or that is based on a promise and an expectation of performance (i.e., under the doctrine of promissory estoppel).

Statement 143 requires that an entity recognize the fair value of a liability for an ARO in the period in which the obligation is incurred. As such, when determining the fair value of an ARO, the concepts of Statement 157 should be applied. However, Statement 157 does not remove the practicability exception that exists in Statement 143, which states, “If a reasonable estimate of fair value cannot be made in the period the ARO is incurred, a liability is not recorded until a reasonable estimate can be made”. Under Statement 143, if a reasonable estimate of fair value cannot be made in the period the ARO is incurred, then no liability should be recognized in that period, but disclosure of the existence of the ARO is required. The recognition of the ARO should be delayed until the period in which a reasonable estimate of fair value can be made. We believe that this exception to recognition of an ARO, both before and after the adoption of Statement 157, will be uncommon, although it may occur if the nature of the retirement activities that will be required to be undertaken are highly uncertain. If the nature of those retirement activities is known, we believe that a company will be expected to develop a reasonable estimate of the fair value of that retirement obligation. While many estimates of fair value require significant judgment, the inherent need for judgment does not serve as a basis to avoid recognition of an ARO liability. The concepts described in Statement 157 should assist entities in determining a fair value measure even when observable information may not be available.

The subsequent measurement of an ARO reflects the change in the ARO resulting from: (1) the passage of time, and (2) revisions to undiscounted cash flow projections. The following bullets describe changes in the ARO, the measurement basis and whether the revised ARO is subject to 157.

- ▶ Change: Changes due to passage of time (accretion)
 - ▶ Accounting: Changes in the carrying amount of the liability due to the passage of time are recognized as an increase in the carrying amount of the liability and as a charge to accretion expense based on the original discount rate (credit-adjusted risk-free rate).

- ▶ Applicability of Statement 157: Accretion does not take into account current market interest rates and credit spreads and, therefore, it is not a fair value measurement subject to Statement 157.
- ▶ Change: Downward revisions in undiscounted cash flows
 - ▶ Accounting: Statement 143 requires that downward revisions in the amount of expected cash flows be discounted at the credit-adjusted risk-free rate that was used when the ARO was initially measured.
 - ▶ Applicability of Statement 157: A downward revision does not take into account current market interest rates and credit spreads and, therefore, it is not a fair value measurement subject to Statement 157.
- ▶ Change: Upward revisions in undiscounted cash flows
 - ▶ Accounting: For upward revisions in expected cash flows, Statement 143 specifies that only the incremental cash flows over initial projections, not all of the expected cash flows, are to be discounted using a current credit-adjusted risk-free rate.
 - ▶ Applicability of Statement 157: Because Statement 143 specifies that only the incremental cash flows over initial projections, not all of the expected cash flows, are to be discounted using a current credit-adjusted risk-free rate, the revised carrying value of the ARO in this situation would not represent a fair value measurement for the entire obligation at the measurement date.

See our Financial Reporting Developments publication, *FASB Statement No. 143, Accounting for Asset Retirement Obligations*, for further discussion.

Key considerations under Statement 157

The fair value of a liability for an ARO is the amount at which that liability could be transferred in a current transaction between willing parties, other than in a forced sale or liquidation transaction. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value should be based on the best information available in the circumstances, including prices for similar liabilities and the results of present value (or other valuation) techniques.

The FASB concluded in Statement 143 that the expected cash flow approach usually would be the only appropriate technique for measuring an ARO liability because (1) estimates of the fair value of an ARO generally will involve an estimate of future cash flows that are uncertain in both timing and amount and (2) observable marketplace prices for those liabilities generally do not exist. When measuring an ARO using an expected cash flow approach, a company should use a discount rate that equates to a risk-free interest rate for an instrument (in the US, a US Treasury security) with a maturity date that coincides with the expected timing of when the asset retirement activities will be performed, adjusted for the effect of the company's credit standing. This rate is referred to in Statement 143 as a "credit-adjusted risk-free rate." In estimating cash flows, a company should also develop numerous assumptions including an estimate of third party costs, future cost assumptions, and required profit margin, the variability in the timing and amount of cash flows and an appropriate market risk premium. It is the determination of the market risk premium that has been the basis of numerous inquiries as to the effect of Statement 157 on AROs.

Market risk premium

Prior to Statement 157, a market risk premium may not have been considered in the valuation model if it was not readily obtainable or its effect was immaterial. Concepts Statement 7 required consideration of a risk premium if the amount was identifiable, measurable, and significant. As noted previously, Statement 157 requires a market risk premium to be an input to a valuation model if a market participant would demand one. The FASB believes that a market risk premium is intended to reflect what a market participant would hypothetically demand for bearing the uncertainty of agreeing to assume an obligation for a fixed price today, when it will satisfy the obligation at some point in the future. The FASB provided no additional guidance in Statement 143 regarding the estimate of an appropriate market risk premium. Challenges arise in estimating a market risk premium for an ARO because the retirement activities are likely to be performed many years in the future, and entities frequently have little information about the incremental amount a market participant would charge to assume the risk of the ARO, because there are very few instances of an ARO being transferred separately to a market participant as contemplated in Statement 157.

While AROs are rarely transferred on a stand-alone basis, they are commonly transferred in business combinations and asset sale transactions. Entities may consider the risk premium that they observed in business combinations when retirement obligations are assumed, including business combination transactions in which the entity participated. In other words, the entity may consider its own data in developing assumptions related to assets and liabilities with little, if any, market activity (including the risk premium that it has obtained in transactions with third parties) provided that contrary information is not available with out undue cost and effort. Another approach may be to consider the difference between a fixed price arrangement with a third party to complete the remediation and monitor the site and a cost-plus arrangement. The difference between the fixed price and cost-plus arrangements may be indicative of the risk premium for an ARO.

Statement 143, paragraph A20, as amended by Statement 157, indicates that an ARO should include explicit assumptions of several factors, including a market risk premium, to the extent possible. However, the implementation guidance with respect to explicit assumptions was not changed through the issuance of Statement 157. A20 reads as follows:

"In estimating the fair value of a liability for an asset retirement obligation using an expected present value technique, an entity shall begin by estimating the expected cash flows that reflect, to the extent possible, a marketplace assessment of the cost and timing of performing the required retirement activities. Considerations in estimating those expected cash flows include developing and incorporating explicit assumptions, to the extent possible, about all of the following:

- a. The costs that a third party would incur in performing the tasks necessary to retire the asset
- b. Other amounts that a third party would include in determining the price of the transfer, including, for example, inflation, overhead, equipment charges, profit margin, and advances in technology
- c. The extent to which the amount of a third party's costs or the timing of its costs would vary under different future scenarios and the relative probabilities of those scenarios

- d. The price that a third party would demand and could expect to receive for bearing the uncertainties and unforeseeable circumstances inherent in the obligation, sometimes referred to as a market-risk premium.

It is expected that uncertainties about the amount and timing of future cash flows can be accommodated by using the expected present value technique and therefore will not prevent the determination of a reasonable estimate of fair value.”

We believe that entities should consider all available evidence about market participant behavior to develop assumptions with respect to a market risk premium. Paragraph A20 specifically acknowledges that explicit assumptions may not be able to be incorporated and this acknowledgement was not changed by Statement 157. As a result, we believe that entities may not be able to determine explicit assumptions for certain inputs such as a market risk premium for AROs in certain instances. In such cases, the market risk premium may be incorporated on an implicit basis. A company that performs an expected cash flow approach that encompasses many different cash flow probabilities (e.g., a Monte Carlo simulation) may effectively incorporate the implicit market risk premium associated with variability into those cash flows. Arguably the more robust an expected cash flow approach is the less likely a premium for variability in cash flows would be significant. Companies may also include an implicit market risk premium in their determination of an appropriate discount rate when explicit evidence of such premium is not available.

Nonperformance risk

The fair value of an ARO, similar to the fair value concepts used for any liability, must include an assessment of a company’s own credit risk. In the case of an expected cash flow technique for determining fair value, an entity’s own credit risk is incorporated in the credit adjusted risk free rate. To the extent other valuation models are used, the fair value of the obligation should also incorporate the nonperformance risk associated with the liability.

Environmental liabilities

The measurement objectives for liabilities that are accounted for under the provisions of Statement of Position 96-1, “Environmental Remediation Liabilities” (SOP 96-1), are not

intended to represent a fair value measurement. As such, environmental liabilities are not measured in accordance with Statement 157. The measurement objective of environmental remediation liabilities should be based on the reporting entity’s estimate of what it will cost to perform each of the elements of the remediation effort when those elements are expected to be performed. If the amount and timing of cash payments for the liability are fixed or reliably determinable, which we believe is rare for these liabilities, the measurement of the liability may be discounted to reflect the time value of money, although that discounted amount does not represent fair value. SOP 96-1, paragraph 132, states that SEC registrants should use a discount rate that “will produce an amount at which the environmental liability theoretically could be settled in an arm’s-length transaction with a third party and that should not exceed the interest rate on monetary assets that are essentially risk-free and have maturities comparable to that of the environmental liability ...”. We do not believe that the rate described would produce a fair value, because the discount rate that a third party would demand would typically be much greater than a risk-free rate.

While SOP 96-1 states that potential recoveries of environmental liabilities should be measured at fair value, potential recoveries are only recognized when they are deemed probable (based on the definition of probable in Statement 5). We believe that a fair value measurement in accordance with Statement 157 would consider the likelihood of the potential recovery, variability in the amount that would be recovered, costs to be incurred to effect the recovery, the time value of money, a market risk premium and other factors noted in Statement 157. However, SOP 96-1 refers solely to transaction costs and the time value of money. The SOP also notes, in an attempt to achieve parity, that to the extent the environmental liability is not discounted, the receivables should not be either.

While we acknowledge that SOP 96-1 uses the term “fair value”, given the variance in how it is described, coupled with the fact that it was not amended by Statement 157, we do not believe that the measurement of recoveries of environmental liabilities under SOP 96-1 is a fair value measurement under Statement 157.

Equity method of accounting

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB 18) prescribes the equity method of accounting for investments in the common stock of corporations when the investor does not control an investee but has the ability to exercise “significant influence” over its operating and financial policies. The equity method of accounting may also be appropriate for investments in general partnerships, limited partnerships, limited liability companies, trusts and other entities. Under APB 18, equity method investments are initially recorded at cost and are subsequently adjusted to recognize the investor’s share of the earnings, losses and/or changes in capital of the investee after the date of acquisition. All dividends received reduce the carrying amount of the investment. Equity method investments are assessed for other-than-temporary impairment in accordance with APB 18.

While APB 18 employs a cost accumulation model, an equity method investment is recorded at its fair value in the following circumstances:

- ▶ Other-than-temporary impairment-A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. APB 18 prescribes that an entity record a loss in the value of an equity method investment if the decline is other-than-temporary. Once there is a determination that an other-than-temporary impairment exists, the equity method investment should generally be reduced to its fair value. The use of an undiscounted cash flow approach to determine whether an impairment of an equity method investment is other than temporary, or to determine the fair value of the investment is not appropriate.⁷
- ▶ Acquisition of an equity method investment in a business combination-In accordance with Statement 141(R), the amount assigned to an acquired company’s investment accounted for under the equity method is the investment’s fair value on the date of acquisition.

⁷ EITF No. 94-1, “Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects” (EITF 94-1), permits a limited partnership investment in a qualified affordable housing project to be accounted for under the equity method in certain circumstances. EITF 94-1 describes an acceptable impairment model for equity method investments under its scope in which the impairment is measured based on undiscounted cash flows. This model is acceptable for investments accounted for pursuant to EITF 94-1 but should not be analogized to investments outside of EITF 94-1’s scope. A fair value model may also be used to measure the impairment of investments accounted for under EITF 94-1.

- ▶ Deconsolidation of a subsidiary when an equity method investment is retained-Pursuant to Statement 160, any ownership interest that remains in a subsidiary upon deconsolidation is measured at its fair value.
- ▶ Fair value option-FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (Statement 159), allows entities to elect to measure certain financial assets and financial liabilities (as well as certain nonfinancial instruments that are similar to financial instruments) at fair value (the “fair value option”). Investments accounted for under the equity method are eligible for the fair value option. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an equity method investment, Statement 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings.

For equity method investments in public companies that are actively traded, fair value would be determined based on the security’s trading price multiplied by the number of shares held. However, the determination of fair value for investments in privately held entities can prove to be more challenging. The valuation of an investment in a privately held entity will often require the use of a valuation model representing an income approach, as well as the market approach, or a cost approach in certain instances such as when an entity is not a going concern. Different methodologies under each of these approaches may produce enterprise values (i.e. total debt plus total equity) or total equity values. If the valuation methodology produces an enterprise value, consideration should be given to the fair value of the total debt and any provisions within the related debt agreement that would affect the valuation of the equity investment. Further, different methodologies under each approach may produce the fair value of a controlling interest or the fair value of a minority interest. Consideration should also be given to any valuation adjustments that may be necessary to appropriately reflect the noncontrolling position that is being valued. Given the complexities in the valuation of an investment in a privately held entity, the use of valuation experts is strongly encouraged.

In accordance with APB 18, intercompany profits and losses should be eliminated until realized by the investor or investee as if the investee were a consolidated subsidiary. In determining the fair value of an equity method investment, consideration should be given to the business relationships between the investor and investee. While the profits and losses of certain transactions between the investor and investee may be fully or partially eliminated in recording the equity method investment, the reporting enterprise will need to evaluate whether a market participant would consider those transactions in determining the fair value of the investment.

Statement 159 allows entities to elect to measure certain financial assets at fair value. At the 2007 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff discussed the application of the fair value option to certain equity interests that have embedded features or performance obligations. For example, in certain partnership arrangements the general partner's interest may include an embedded feature that provides the general partner with a disproportionate allocation of returns (e.g. "carried interest"). If the general partner's investment includes a substantive performance obligation to an equity method investee, such as management services, the carried interest may represent compensation for services to be performed. If so, measuring the investment at a fair value by giving consideration to the carried interest may result in gain recognition for profits associated with future performance obligations. Thus, the SEC staff believes entities should consider whether a substantive non-financial obligation is embedded in a financial instrument and careful consideration should be given as to whether the fair value option is even available in circumstances in which a substantive non-financial obligation is embedded in an investment accounted for under the equity method. As discussed above, there are circumstances outside of an application of Statement 159 where equity investments are reported at fair value. In those cases, the elements of the equity method investment should be analyzed so that appropriate consideration is given to any performance obligation when determining the fair value of the investment.

Consolidation accounting

FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (FIN 46(R)), clarifies the application of ARB No. 51, *Consolidated Financial Statements* (ARB 51), to certain entities in which the equity investors do not have characteristics of a controlling financial interest (i.e., they lack certain decision-making ability) or do not have sufficient equity at risk for the entity to finance its activities without additional financial support. These entities are known as variable interest entities (VIEs). FIN 46(R) requires an enterprise holding a variable interest (i.e., an interest that absorbs the variability of changes in the fair value of the VIE's assets) in an entity to determine whether the entity is a VIE and, if so, to determine whether the enterprise is the primary beneficiary of the VIE. In general, a VIE's primary beneficiary absorbs the majority of the VIE's variability, as determined through a quantitative analysis. The primary beneficiary consolidates the VIE.

Statement 160 was issued as an amendment to ARB 51 and is based on the economic entity concept of consolidated financial statements. Under the economic entity concept, all residual economic interest holders in an entity have an equity interest in the consolidated entity, even if the residual interest is relative to only a portion of the entity (i.e., a residual interest in a subsidiary). Therefore, Statement 160 requires that a noncontrolling interest in a consolidated subsidiary be displayed in the consolidated statement of financial position as a separate component of equity. Statement 160 also concluded that:

- ▶ After control is obtained, a change in ownership interests that does not result in a loss of control should be accounted for as an equity transaction, and
- ▶ A change in ownership of a consolidated subsidiary that results in a loss of control and deconsolidation is a significant event that triggers gain or loss recognition, with the establishment of a new fair value basis in any remaining ownership interests.

Statement 160 carries forward, without reconsideration, many of the provisions of ARB 51 related to consolidation policies and procedures including the elimination of intercompany transactions.

Fair value considerations

The following bullets outline fair value accounting considerations related to FIN 46(R) and Statement 160.

- ▶ **Fair value of variable interests** – In evaluating the provisions of FIN 46(R), an enterprise is required to determine the fair value of the variable interests in an entity in certain circumstances. In particular, when applying FIN 46(R)'s business scope exception, the reporting enterprise must consider whether it and its related parties provide more than half of the total of subordinated financial support provided to the entity based on analysis of the fair values of the interests in the entity. Additionally, an enterprise must determine the fair value of the equity investment at risk when evaluating the sufficiency of the equity at risk as part of the VIE determination.
- ▶ **Expected losses and expected residual returns** – An enterprise consolidates a VIE if that enterprise has a variable interest(s) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. The determination of a VIE's expected losses and expected residual returns requires an enterprise to determine the fair value of the VIE.
- ▶ **Initial measurement (subsequent to the adoption of Statement 141(R))** – Except for enterprises under common control and assets and liabilities that are consolidated shortly after transfer from a primary beneficiary to a VIE, the primary beneficiary of a VIE shall initially measure the assets (except for goodwill if the VIE is not a business), liabilities, and noncontrolling interests of the VIE in accordance with Statement 141(R) on the date the enterprise becomes the primary beneficiary.
- ▶ Under Statement 160, a parent company deconsolidates a subsidiary when that parent company no longer controls the subsidiary. When control is lost, the parent-subsidiary relationship no longer exists and the parent derecognizes the assets and liabilities of the subsidiary. A gain or loss is recognized upon the deconsolidation of a subsidiary based upon the fair value of consideration received and the fair value of any remaining ownership interest in the subsidiary.

Measurement considerations

Under FIN 46(R), the determination of the fair value of variable interests in an entity generally requires considerations that are consistent with the valuation of equity interests.

In determining fair value, Statement 157 does not prescribe whether a risk premium should be captured in the discount rate or in the expected cash flows when using an income approach. In calculating the expected losses and expected residual returns in accordance with FIN 46(R)'s provisions, the risk of uncertainty is generally captured in the variability of the cash flows. Therefore, we believe when making the VIE and primary beneficiary determinations under FIN 46(R), cash flows would be discounted using a risk-free rather than a risk-adjusted rate.⁸

Generally, the primary beneficiary measures a VIE's assets, liabilities, and noncontrolling interests in accordance with Statement 141(R) (subsequent to its adoption) on the date the enterprise becomes the primary beneficiary. However, goodwill is only recognized for VIEs that are businesses. Refer to the "Business combinations" section for a discussion of the Statement 141(R) fair value considerations.

In determining the gain or loss upon deconsolidation of a subsidiary under Statement 160, an entity must determine both the fair value of both the consideration received and any retained interest in the subsidiary. Oftentimes, the consideration received will be in the form of cash making the fair value determination relatively straightforward. In determining the fair value of any retained interest in the subsidiary, consideration should be given to the discussion in the "Equity method of accounting" section for retained equity method investments. Additionally, refer to the discussion on the valuation of noncontrolling interests in the "Business combinations" section.

Revenue recognition

In general, the fair value principles outlined in Statement 157 do not have a significant effect on the measurement and/or recognition of revenue for most transactions. This is due, in part, to the fact that fair value is not a pervasive concept in revenue accounting standards, most notably, Staff Accounting Bulletin No. 104, *Revenue Recognition* (Topic 13).

⁸ Refer to FAQ 8-17, Chapter 8 and Appendix C of the EY Financial reporting developments publication, FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, for further discussion.

However, certain revenue accounting standards do refer to fair value measurements. Two statements that have wide applicability for many companies across industries are EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables* (Issue 00-21), and AICPA Statement of Position No. 97-2, *Software Revenue Recognition* (SOP 97-2). These standards both address the accounting for multiple-element arrangements and utilize the concept of vendor-specific objective evidence (VSOE) of fair value (and, in the case of Issue 00-21, third-party evidence of fair value as a proxy for VSOE of fair value) in determining whether deliverables included in multiple-element arrangements may be accounted for as separate units of accounting. The scope of Statement 157 specifically excludes accounting pronouncements that use fair value estimates based on VSOE, as Statement 157 does not apply to pronouncements that have similar concepts of fair value but are not intended to measure fair value.^{9,10} Therefore, fair value measurements of EITF 00-21 and SOP 97-2 are not within the scope of Statement 157.¹¹

Although we do not expect Statement 157 to affect many revenue recognition transactions, there are certain sections of revenue recognition guidance that are affected. For example, AICPA Statement of Position No. 00-2, *Accounting by Producers or Distributors of Films* (SOP 00-2), requires fair value measurements in two primary areas: (1) the fee in a multiple film arrangement is allocated based on the relative fair values of the exploitation rights for each film and (2) an impairment charge is recorded to the extent the unamortized carrying amount of capitalized film costs exceeds the fair value of the film.

The calculation of fair value is not specifically defined within SOP 00-2, but reference is made to a hierarchy of methods for determining fair value provided in Statement 121,

Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, which has been subsequently superseded by Statement 144. Since Statement 157 ultimately superseded the guidance surrounding fair value measurements within Statement 144, we believe the fair value measurements of SOP 00-2 are subject to the provisions of Statement 157. Applying the exit price concepts in Statement 157 could potentially change current practice; however, in many respects, SOP 00-2 discusses the use of inputs that are consistent with Statement 157 Level 3 inputs. We believe that it is likely that such inputs are already used in practice in the determination of fair value measurements pursuant to SOP 00-2.

Additionally, certain revenue-related pronouncements refer to fair value, but provide guidance relating to its determination that is specific to the application of that standard. In such instances, we believe that the provisions of the applicable standard should be followed and not the provisions of Statement 157. For example, EITF Issue No. 99-17, "Accounting for Advertising Barter Transactions" (Issue 99-17), provides that revenues and expenses from an advertising barter transaction should be recognized at fair value only if the fair value of the advertising surrendered in the transaction is determinable based on the entity's own historical practice of receiving cash for similar advertising from buyers unrelated to the counterparty in the barter transaction. The population of prior cash transactions that should be utilized to determine fair value should be limited to transactions entered into within six months prior to the date of the barter transaction (subject to certain conditions). Because the guidance regarding the determination of "fair value" within Issue 99-17 was not amended by Statement 157, we believe this guidance should continue to be applied to fair value measurements related to transactions within its scope.

The following is a discussion of additional revenue recognition standards that we expect to be affected by Statement 157.

Consideration given by a vendor to a customer

EITF Issues No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)", and No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor", provide guidance on the accounting by a vendor

⁹ Statement 157 notes in paragraph 3 that the Statement "does not apply under accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value" and indicates that SOP 97-2 and EITF 00-21 are two such pronouncements.

¹⁰ In its recent consensus-for-exposure on Issue 08-1, *Revenue Arrangements with Multiple Deliverables*, the EITF agreed to replace the current references to "fair value" within Issue 00-21 with the term "selling price." In agreeing to this change, the EITF also noted that the current fair value terminology in Issue 00-21 is not intended to represent a fair value measurement subject to Statement 157. The EITF also noted that the revisions to refer to selling price instead of fair value are not intended to result in a change in practice.

¹¹ We believe this exclusion also applies to standards relating to the use of SOP 97-2, such as EITF Issue 00-3, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*, and the multiple SOP 97-2 related Technical Practice Aids issued by the AICPA.

and a customer, respectively, for consideration provided by a vendor to a customer. In order for either the customer or the vendor to account for such consideration separately from other transactions between the two parties, there must be an identifiable benefit associated with the consideration and the fair value of that benefit must be reasonably estimable.

We believe the guidance within Statement 157 should be applied to “reasonably estimate” the fair value of the identifiable benefit. We believe this is likely a change from current practice where Level 3 valuations, such as management’s estimates, may not be considered sufficient evidence to demonstrate a reasonably estimable fair value. Additionally, the exit price concept within the definition of fair value in Statement 157 will require that entities consider that the entry price may not equal the exit price. This is despite the current general practice to focus on transaction prices (i.e., an entry price) with third parties to reasonably estimate the fair value of an identifiable benefit provided to a vendor by a customer.

Franchise fee revenue

Under the guidance in Statement 45, *Accounting for Franchise Fee Revenue*, the franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. However, the fee may also cover tangible property, such as signs, equipment, inventory and land and buildings. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

Fair value measurements of tangible property within franchise agreements have traditionally been based on transaction prices for the property with third parties. Therefore, while transaction prices may still represent relevant data in estimating fair value, the application of Statement 157 could potentially change current practice by permitting the use of management estimates in determining an exit price for these assets (i.e., Level 3 measurements).

Financial reporting by broadcasters

Pursuant to Statement 63, *Financial Reporting by Broadcasters*: (1) a licensee shall report the asset and liability for a broadcast license agreement either (a) at the fair value of the liability or (b) at the gross amount of the liability; (2) broadcasters may

barter unsold advertising time for products or services. All barter transactions except those involving the exchange of advertising time for network programming shall be reported at the estimated fair value of the product or service received, and; (3) network affiliation agreements and other such items ordinarily are presented in the balance sheet of a broadcaster as intangible assets. If a network affiliation is terminated and not immediately replaced or under agreement to be replaced, the unamortized balance of the amount originally allocated to the network affiliation agreement shall be charged to expense. If a network affiliation agreement is terminated and immediately replaced or under agreement to be replaced, a loss shall be recognized to the extent that the unamortized cost of the terminated affiliation agreement exceeds the fair value of the new affiliation agreement.

Addressing the respective points above: (1) if the asset and liability are measured at the fair value of the liability, instead of the gross amount of the liability, we believe the concepts in FAS 157 should be followed; (2) We believe the guidance included in Statement 63 relating to the accounting for barter transactions is an interpretation of the general principle in Statement 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29*, that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. Accordingly, we believe that any estimate of fair value for purposes of applying this provision of Statement 63 should be made using the principles established by Statement 157, and; (3) we believe that the principles established by Statement 157 should be followed when estimating the fair value of the new network affiliation agreement for purposes of evaluating whether a loss should be recognized.

Inventory and certain other costs

As previously noted, the provisions of Statement 157 are not applicable to measurement objectives under US GAAP that are similar to fair value but that are not intended to represent a fair value measurement. Such measurements include inventory pricing within the scope of Accounting Research Bulletin No. 43 (ARB 43), Chapter 4 Inventory Pricing. As a result, most inventory-related measurements are not affected by Statement 157. For example, the term “market value” as used in a lower of cost or market (LOCOM) measurement objective is specifically defined within ARB 43

and therefore not intended to represent a fair value measurement as would be determined under Statement 157. This exclusion from Statement 157 also applies to interim inventory measurements as discussed in EITF 86-13, *Recognition of Inventory Market Declines at Interim Reporting Dates*, and the net realizable value concepts for videocassettes and digital video disc inventory of film and entertainment companies as discussed in SOP 00-2.

While many inventory costing measurements are excluded from the scope of Statement 157, there are certain situations where inventory measurement and other cost-related principles within existing accounting guidance are intended to measure fair value. The guidance of Statement 157 should be applied to such measurements.

The following discussion summarizes inventory and certain cost-related guidance that references fair value measurements and is affected by Statement 157.

Accounting for purchase and sales of inventory with the same counterparty

EITF 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty* (Issue 04-13), addresses the circumstances under which two or more inventory purchase and sale transactions with the same counterparty should be viewed as a single transaction and accounted for at fair value as a nonmonetary transaction pursuant to Statement 153.

Transactions that are accounted for as nonmonetary transactions in accordance with Statement 153 are within the scope of Statement 157. Accordingly, Statement 157's guidance on determining fair value is applicable to purchases and sales of inventory with the same counterparty that should be accounted for at fair value pursuant to the provisions of Issue 04-13.

Accounting for costs incurred through a contract that are both capitalizable and non-capitalizable

SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP 98-1), addresses the capitalization costs incurred for the development or purchase of computer software. This guidance requires that if costs incurred from a third-party provider include both

capitalizable and non-capitalizable amounts, the total consideration paid must be allocated among the identifiable elements of the contract based on the "objective evidence of fair value."

EITF 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, addresses a similar topic, which is costs incurred in connection with a consulting contract where some costs are capitalizable and others are not. The issue concludes that the total consulting contract price should be allocated to each activity within the contract based on the relative fair value of the separate activities, based on the "objective evidence of fair value" of those activities.

As SOP 98-1 makes clear, the concept of "objective evidence of fair value" to be used in applying its provisions is not vendor-specific evidence of fair value (as defined by SOP 97-2). We believe that this provision of SOP 98-1 is a fair value measurement within the scope of Statement 157. Further, we believe that this is also true for the guidance within EITF 97-13.

Leases

Statement 157's definition of fair value does not apply to fair value measurements for the purposes of lease classification and measurement under Statement 13, and its related accounting pronouncements. Although the definition of fair value¹² in Statement 13 is similar to the definition of fair value in Statement 157, the framework for measuring fair value under Statement 13 is not consistent with the framework for measuring fair value under Statement 157. For example, Statement 13 provides that the fair value of leased property in certain lease arrangements will ordinarily be the lessors' cost of the property reflecting any volume or trade discounts that may be applicable (i.e., a transaction or entry price); whereas, under Statement 157, fair value represents an exit price, not an entry price. Accordingly, Statement 157 does not affect certain fair value measurements such as the fair value of leased property, which is used in classifying a lease and to determine the maximum amount at which a lessee can record an asset leased under a capital lease. The FASB decided to exclude

¹² Paragraph 5(c) of Statement 13 defines the fair value of leased property as "The price for which the property could be sold in an arm's-length transaction between unrelated parties."

these fair value measurements from the scope of Statement 157 due to concerns that the application of the fair value definition in Statement 157 could result in unintended consequences, such as changing the classification of leases that would otherwise be accounted for as direct finance leases to either sales-type or operating leases.

Although Statement 13 and its related pronouncements are excluded from the scope of Statement 157, as previously discussed in this document certain other fair value measurements of lease arrangements need to be determined in accordance with the principles in Statement 157. For example, fair value measurements associated with lease assets acquired or liabilities assumed in a business combination under Statement 141(R), the impairment of assets under capital leases under Statement 144, and the measurement of termination costs related to operating leases under Statement 146 are all subject to the measurement guidance in Statement 157. These items are discussed further in the “Business combinations”, “Long-lived assets”, and “Exit or disposal activities” section of this document.

Income taxes

Statement 157 did not amend the measurement requirements in FASB Statement No. 109, *Accounting for Income Taxes* (Statement 109). See our publication, *Financial Reporting Developments – Accounting for Income Taxes*, for a further discussion of the requirements of Statement 109. That being said, the measurement principles in Statement 157 could affect the financial reporting bases (i.e., book bases) of assets or liabilities that are used to determine temporary differences and to calculate deferred income taxes. As such, the adoption of Statement 157 could indirectly affect deferred income taxes depending on the nature of an entity’s underlying assets and liabilities and the extent to which their estimated fair values are affected by applying the guidance in Statement 157.

Non-monetary exchanges

FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*, specifies that exchanges of nonmonetary assets are accounted for at the fair value of the assets being exchanged if the exchange has commercial substance. If the exchange has commercial substance, then the fair values of the assets exchanged is determined based upon the guidance in Statement 157. Considerations regarding the determination of fair value for various assets are described in this article and should be applied when the various assets are included in a nonmonetary exchange.

Appendix A – Valuation considerations for business combination-related measurements

Asset/Liability	Valuation Considerations
Contingent consideration	<ul style="list-style-type: none"> ▶ May be an asset or liability to the acquirer. ▶ The potential obligation of the acquirer to pay contingent consideration should be classified as a liability or as equity in accordance with FASB Statement 150, EITF Issue No. 00-19, or other applicable GAAP. ▶ The potential return of a portion of the already transferred consideration should be classified as an asset by the acquirer. ▶ The structure of the payout may define the fair value approach: <ul style="list-style-type: none"> ▶ Linear payout function(e.g., Payout = 3x target’s next fiscal year earnings before interest and taxes, “EBIT”) <ul style="list-style-type: none"> ▶ Value associated with the probability-weighted average outcomes will be equal to the probability-weighted average of the values associated with each outcome (i.e., a single probability-weighted EBIT projection can be used to estimate the fair value). ▶ Nonlinear payout function (e.g., Payout = zero if target’s next fiscal year EBIT < \$10 million or 3x target’s next fiscal year EBIT if EBIT >= \$10 million) <ul style="list-style-type: none"> ▶ Payout is kinked because some outcomes lead to no payout. Hence, the possible outcomes matter. ▶ One approach to address nonlinear payout functions is to probability-weight discrete outcomes (may be difficult for reporting entities to support assumptions about likely outcomes and estimating discount rates can be challenging because they should incorporate the risk associated with the option payout’s distributional properties). ▶ Another approach is to use a simulation model to project possible outcomes (this represents a more robust analysis in a risk-neutral framework, but estimating the volatility of the underlying asset, EBIT in this case, may prove difficult).
Accounts receivable	<ul style="list-style-type: none"> ▶ The risk associated with expected uncollectible amounts should be captured in the fair value estimate and not separately recognized as a valuation allowance ▶ Profit for servicing receivables should incorporate market participant expectations ▶ The discount rate should reflect the time value of money including an appropriate cost of carry, as well as any credit risk not adjusted for previously in the valuation model.
Finished goods inventory	<ul style="list-style-type: none"> ▶ We do not believe that the measurement of finished goods inventory has changed significantly from prior practice. ¹³ ▶ Fair value, in most instances, will approximate a market participant’s estimated selling price adjusted for (1) costs of the selling effort, and (2) a profit allowance for the selling effort.

¹³ While significant changes to prior practice would not be expected, certain clarifications made in Statement 157 could affect fair value estimates (e.g., clarification that fair value represents an exit price that may differ from the entry price for an asset or liability).

Asset/Liability	Valuation Considerations
Work-in-process inventory	<ul style="list-style-type: none"> ▶ We do not believe that the measurement of work-in-process inventory has changed significantly from prior practice ▶ Fair value, in most instances, will approximate a market participant's estimated eventual selling price adjusted for (1) costs to complete, (2) costs of the selling effort, and (3) a profit allowance for efforts to complete and to sell.e
Raw materials inventory	<ul style="list-style-type: none"> ▶ We do not believe that the measurement of raw materials inventory has changed significantly from prior practice ▶ Fair value represented by price a market participant could receive in a current sale of the raw materials (i.e., an exit price).
Plant and equipment	<ul style="list-style-type: none"> ▶ Determination of "in use" versus "in exchange" valuation premise is key to fair value estimate ▶ Market participant assumptions and assumptions consistent with current market conditions should be used in estimating the fair value, including estimates of physical depreciation, and economic and functional obsolescence. ▶ Refer to section on long-lived assets in the body of this document for additional considerations.
Mineral rights	<ul style="list-style-type: none"> ▶ Considered tangible assets under SFAS 141(R) ▶ Cash flows for potential reserves beyond "proven and probable" reserves and estimates of future market price changes should be incorporated in fair value estimates. ▶ Refer to section on long-lived assets in the body of this document for additional considerations.
Identifiable intangible assets	<ul style="list-style-type: none"> ▶ The adoption of Statement 157 is not expected to result in significant changes to the valuation techniques used in estimating fair value, but market participant considerations may have an effect on assumptions in some cases. ▶ The intent of the acquirer (including use, disposal or holding the asset for protective value) is irrelevant to the valuation, which will likely change practice when forming assumptions of expected cash flows (specifically for trademarks and developed technology). ▶ Careful consideration should be given to the "in use" or "in exchange" premise of value, especially when the asset will be used defensively (to keep other market participants from benefiting from the asset). ▶ Refer to section on long-lived assets in the body of this document for additional considerations.

Asset/Liability	Valuation Considerations
In-process research and development assets ("IPR&D")	<ul style="list-style-type: none"> ▶ IPR&D is recognized at its acquisition date fair value in a business combination. The concept that IPR&D must be measurable with reasonable reliability to be recognized no longer applies. ▶ Uncertainty about the outcome of an individual project does not affect the recognition of an IPR&D asset, but does affect its fair value. ▶ When using an income approach, careful consideration should be given to the development of expected cash flows and appropriate discount rates for those cash flows. ▶ Refer to considerations noted above pertaining to contingent considerations as an example of incorporating uncertainty into valuations.
Notes payable / accounts payable / long-term debt	<ul style="list-style-type: none"> ▶ Statement 157 clarifies that the fair value of a liability should consider the risk that the acquirer will not be able to satisfy the obligation (i.e., nonperformance risk). ▶ Nonperformance risk should be assumed to be the same before and after its transfer.
Deferred revenue	<ul style="list-style-type: none"> ▶ Fair value may be measured based on assumptions regarding market participants' estimates of the costs that will be incurred to fulfill the obligation plus a "normal" profit market for the level of effort required. ▶ Appropriate discount rates should consider market risk premiums and nonperformance risk as applicable.
Pre-acquisition contingencies	<ul style="list-style-type: none"> ▶ FSP FAS 141(R)-1 generally reverts accounting for pre-acquisition contingencies to guidance provided in SFAS 141. ▶ Refer to our Hot Topic No. 2009-12 (3 April 2009) for further guidance.
Long-term construction contracts	<ul style="list-style-type: none"> ▶ Fair value is not affected by the method of accounting to be used by the acquirer after acquisition, or that has been used by the target for acquisition (i.e., the completed contract or percentage-of-completion method). ▶ Prior practice has been to estimate the fair value of long-term construction contracts for purchase accounting in a manner that measures expected revenues and subtracts costs to complete, disposition costs and a profit yet to be earned (similar to the methodology that Statement 141 outlines for estimating the fair value of inventory for purchase accounting purposes). ▶ We believe the above-mentioned method represents more of a profit-splitting exercise that is conducive to percentage-of-completion accounting than an approach to estimating fair value as contemplated by the exit price notion of Statement 157. ▶ A present value technique, as described in Appendix B of Statement 157, that estimates future cash flow streams from the contract and discounts them at an appropriate required rate of return would seem a more appropriate approach to meet the objectives of fair value.

Asset/Liability	Valuation Considerations
Leases (lessee)	<ul style="list-style-type: none"> ▶ Operating leases – To the extent the lease arrangement is favorable or unfavorable relative to market conditions on the acquisition date, an asset or liability is recognized for the off-market component as of the acquisition date. In addition, a value, if any, is ascribed to the in-place lease. ▶ Capital lease assets – Assets under capital leases should be recognized at fair value as of the acquisition date using concepts for measuring and recognizing assets acquired and should be considered independent of the fair value of the lease contract. ▶ Capital lease obligation – Fair value should be measured in a manner similar to assumed debt, including considerations for nonperformance risk. ▶ We generally do not expect that a separate intangible asset or liability will be recognized for the inherent or off-market fair value of a capital lease arrangement; rather those values would be reflected in the measurement of the assets under capital lease and the capital lease obligation
Leases (lessor)	<ul style="list-style-type: none"> ▶ Operating leases – To the extent the lease arrangement is favorable or unfavorable relative to market on the acquisition date, an asset or liability is recognized at fair value as of the acquisition date. In addition, a value, if any, is ascribed to the in-place lease. A customer relationship intangible asset may also be recognized.
Noncontrolling interests	<ul style="list-style-type: none"> ▶ See Equity Method of Accounting section of this publication.
Share-based payments	<ul style="list-style-type: none"> ▶ Share-based payments accounted for under Statement 141(R) should be measured in accordance with the fair-value-based measurement requirements of SFAS 123(R), Share-based Payment

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