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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **Fair Value Measurement**

Subject: **Valuation premise (Agenda paper 3C)**

Purpose of this paper

1 This paper considers the notion of valuation premise. For example, should a fair value measurement consider whether market participants would maximise the value of an asset principally through its use in combination with other assets as a group (in-use) or on a standalone basis (in-exchange)?

Introduction

2 The valuation premise was not specifically addressed in the *Fair Value Measurements* discussion paper and IFRSs do not explicitly address the valuation premise. However, question 17 of the discussion paper asked whether the difference between the in-use valuation premise in FASB Statement of Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) and the value in use measurement basis in IAS 36 *Impairment of Assets* was clear.

3 In the discussion paper, the Board noted that the ‘value in use’ measurement basis in IAS 36 incorporates an estimate of future cash flows that the entity expects to derive from the asset (or asset group) and does not require those cash flows to be adjusted to reflect market participant expectations. Therefore, the resulting value is an entity-specific value. In comparison, a fair value measurement determined using an in-use valuation premise is a market-based measurement, not an entity-specific measurement.

4 Although most respondents felt that the distinction between the in-use valuation premise in SFAS 157 and value in use in IAS 36 is clear, many of them raised concerns about the practical implementation of the valuation premise. In particular, many were unsure how to reconcile the in-use valuation premise in SFAS 157 with an exit price notion of fair value.

5 This paper is organised as follows:

a guidance in SFAS 157

b questions raised about the SFAS 157 approach

c distinguishing between the in-use valuation premise and value in use

d application to financial assets

e application to liabilities

Guidance in SFAS 157

6 The highest and best use of an **asset**[1] establishes the valuation premise used to measure the fair value of the asset.[2] The valuation premise determines whether market participants would maximise the value of the asset by using the asset in combination with other assets as a group (in-use) or on a standalone basis (in-exchange).

[1] This paper focuses on the valuation premise for **assets** because that is the focus of SFAS 157. Paragraphs 45-51 address the application of the valuation premise to liabilities.
[2] In September 2008 the Board tentatively decided that the fair value of an asset should reflect its highest and best use.

7 In other words, a fair value measurement is the *higher* of the fair values derived from the in-use and in-exchange valuation premises (and depending on the unit of account, these might be the same). These are described in SFAS 157 as follows:

> **In-use:** The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (installed or otherwise configured for use)... When using an in-use valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group *and that those assets are available to market participants*… (SFAS 157.31(a); emphasis added)
>
> **In-exchange:** The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis... When using an in-exchange valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone. (SFAS 157.13(b))

8 Note that the in-exchange valuation premise does **not** assume a fire sale disposal or liquidation value. An asset in-exchange is being used in the business, but it might generate value on its own rather than in combination with other assets. It also might generate value by being sold.

9 SFAS 157 states that the in-use valuation premise might pertain to non-financial assets and the in-exchange valuation premise might pertain to financial assets.

10 Generally, the highest and best use of the asset should be consistent for all assets of the group within which it would be used. For example, if an asset group is comprises a building and the equipment in the building and market participants would maximise the value of the equipment by using it, the valuation premise for both the equipment and the building would be in-use. This ensures consistency in the overall valuation.

11 It is important to note that, regardless of whether the valuation premise is in-use or in-exchange, fair value (as described in SFAS 157) is the estimated price for which the asset would be sold *on its own*. The in-use valuation premise does not assume that the asset group is sold together. Rather, the in-use valuation premise assumes that the market participant buyer has (or could obtain) the complementary assets to use or operate the asset being measured.

12 Paragraph C38 in the Basis for Conclusions of SFAS 157 reconciles the in-use valuation premise and the exchange notion in the definition of fair value:

> Whether using an in-use or an in-exchange valuation premise, the measurement is a market-based measurement determined based on the use of an asset by market participants, not a value determined based solely on the use of an asset by the reporting entity (a value-in-use or entity-specific measurement).

13 In other words, the in-use valuation premise is used if a market participant buyer would take into account the value it expects to generate from *using* the asset (whether it is using the asset in combination with other assets or on its own) when determining what it is willing to pay for the asset.

Questions raised about the SFAS 157 approach

14 This section addresses the questions raised about the valuation premise concept in SFAS 157. These questions come from the comment letters received on the *Fair Value Measurements* discussion paper, the FASB's Valuation Resource Group and other sources.

15 The questions raised include:

a How can the in-use valuation premise and an exit price be reconciled?

b How is fair value allocated when the unit of valuation differs from the unit of account?

How can the in-use valuation premise and an exit price be reconciled?

16 The exit price definition of fair value assumes a sale. Some wonder how the exit price can reflect the fact that an asset is being used in the business, particularly when an entity intends to continue using the asset in the business. They think it internally inconsistent to assume that an entity can use and sell an asset at the same time.

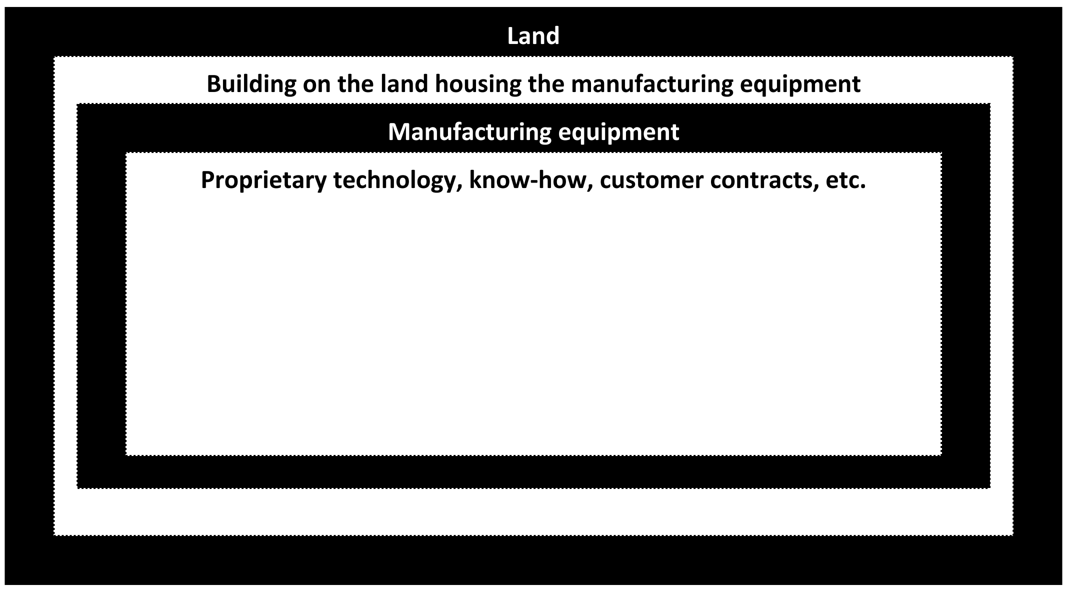
17 Because of this, in July 2008 the Board tentatively decided to define fair value as a current exit price, and asked the staff to develop wording forthe definition reflecting the fact that an exit price considers a market participant's ability to generate economic benefit by using an asset or by selling it to a third party. This section focuses on that issue.

18 Some also think there might be a discontinuity between the entity's intentions to use an asset and the exit price notion. They believe this might distort the performance reported by the entity. They are concerned that, if the in-use value is lower than the in-exchange value, the fair value will be based on the latter and the entity will record a gain that will not materialise. Subsequently, the entity will report lower profitability because it is using the asset and did not dispose of it. The staff thinks this is a consequence of a fair value measurement—portraying the entity's performance relative to market expectations.

19 In the staff's view, the in-use valuation premise in SFAS 157 produces an exit price that differs from a liquidation value. For example, a single machine in a production process has limited value on its own. However, when combined with the other machines and the know-how of the workforce that operates them (with the asset group being the production process) the value will be different (usually higher). Without the in-use valuation premise, the fair value of the single machine would be measured on a liquidation value basis. Clearly the value of such a machine is derived from the fact that it is being used in combination with other assets. A liquidation value would not reflect this.

20 Figure 1 shows an asset group in which each of the assets is in-use.[3] Note that the asset group consists of both tangible and intangible assets.

Figure 1. Inter-relationships within an asset group



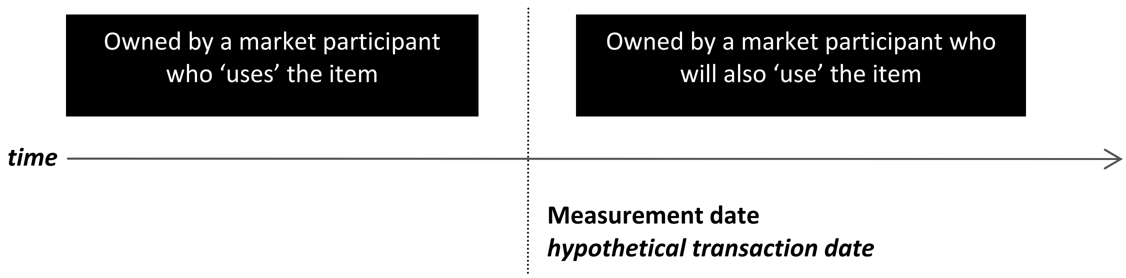
21 As noted above in paragraph 12, the FASB acknowledged that a market participant buyer will take into account the value it expects to generate from *using* the asset (whether it is using the asset in combination with other assets or on its own) when determining how much it would be willing to pay for the asset. A market participant *seller*, therefore, cannot demand a price higher than the buyer is willing to pay based on the buyer's plans for the asset (which might be in-use, or it might be in-exchange). Both parties to the transaction must be considered—both the seller and the buyer must be willing to enter into the transaction.

22 Figure 2 shows that, all else being equal, a change in ownership does not change the fair value of an asset. The measurement date is the date of a hypothetical transaction that provides a reference point of reference for the valuation. The fair value on either side of

[3] Determining the appropriate asset grouping depends on the circumstances. See paragraph 32 below.

the dotted line is the same (except for the passage of time and any changes in market conditions).

Figure 2. Selling an asset assuming the in-use valuation premise



23 Of course, this assumes that the entity is using the asset in its highest and best use and that market participants also will use the item in-use (not in-exchange). But what if 'all else is not equal'? What if the reporting entity uses the asset differently from market participants? As noted above, in such situations, an exit price provides useful information about the reporting entity's efficiencies or inefficiencies relative to market participants.[4]

24 It is important to remember that the in-use valuation premise assumes that market participants have or could obtain the complementary assets necessary to use or operate the asset being measured. Some think this is unrealistic, particularly for specialised assets. They think that the exit price for such assets would be determined on a scrap basis because, although they have value to the entity, they have little or no value to other market participants who cannot use them in the same manner. The staff thinks SFAS 157 is clear on this point: exit price is the (estimated) price for a transfer to market participants who have (or could obtain) the complementary assets.[5]

[4] By 'efficiencies' the staff does not mean only operating efficiencies or inefficiencies. Rather, it also means the entity's ability to exploit the opportunities available to it, relative to the opportunities available to market participants.

[5] The assumption that the complementary assets are available to market participants is a necessary one—after all, if an entity is trying to measure the in-use fair value of its own assets it must have the complementary assets to generate value from them.

25 The staff thinks the concept in SFAS 157 is appropriate, but believes that SFAS 157's description of the in-use valuation premise does not adequately articulate how it relates to an exit price. As noted in paragraph 17, in July 2008 the Board asked the staff to develop wording for the definition of fair value reflecting the fact that an exit price considers a market participant's ability to generate economic benefit by using an asset or by selling it to a third party. The staff agrees that the exposure draft should highlight this fact. However, the staff thinks that the definition of fair value is not the best place to make this point for the following reasons (*pending the Board's decisions on these issues, to be discussed at this meeting*):

a the valuation premise relates only to assets and

b the valuation premise is not applicable for financial assets.

How is fair value allocated when the unit of valuation differs from the unit of account?

26 Footnote 8 of SFAS 157 states that the fair value of an asset in-use considers the use of the asset in combination with other assets as a group (consistent with the highest and best use from the perspective of market participants), even if the asset is aggregated or disaggregated at a different level when applying other accounting standards.

27 The level of aggregation or disaggregation at which an entity determines the fair value of an asset is known in practice as the 'unit of valuation'. This might be different from the unit of account. Some have asked how to allocate the fair value of the unit of valuation to the unit(s) of account required by a particular standard.

28 The staff does not consider this a process of allocation. Rather, individual non-financial assets are measured in the context of their use within an asset group. Rarely is an asset valued as a residual. For example, most non-financial assets (eg tangible and intangible assets acquired in a business combination (and measured at fair value) are measured separately, but as assets that operate with other assets. The appendix to this agenda paper contains an example illustrating the application of the fair value measurement approach to operating machinery.

29 The most common valuation methodology for tangible assets is a replacement cost approach. This is because it is uncommon to find an observable market price for an identical or a similar asset in the same condition and configuration. The more specialised an asset (including its configuration and its use with or interdependency on other assets), the less easily replaceable it is and the less likely it is that an observable market price will reflect its fair value (without significant adjustment to that price). As a result, a market approach cannot be used. Such assets also typically do not generate income directly and therefore an income approach cannot be used.

30 A commonly used methodology for valuing intangible assets is the multi-period excess earnings approach. In this approach, to the extent possible, the cash flows of the business are attributed to the intangible asset being valued. However, other assets contribute to the generation of those cash flows. These other assets are called ‘contributory assets’.[6] The cash flows generated by these contributory assets are deducted from the cash flows of the subject intangible asset to arrive at the cash flows generated solely by that intangible asset. Although this is process of allocation, it is done at the lowest level possible and in the context of the assets’ value contribution to the entire business.

31 Returning to Figure 1 above, an entity does **not** begin by measuring the fair value of the entire asset group comprising land, buildings, machinery and intangible assets and then allocating that value to each of the underlying assets. Instead, for example, the fair value of the machinery is measured assuming it is used within the business (as installed or otherwise configured for use). For fixed assets, such as machinery, a replacement cost approach captures this because it considers the cost to replace the asset in its current location and condition and assumes that the asset is used with those other assets (if that is its highest and best use).

32 Some note that there is no guidance in SFAS 157 on how an asset group is determined, nor does it address the fact that more synergies are introduced at higher levels of

[6] The concept behind contributory assets is that intangible assets do not generate cash flows in a vacuum; they also rely on the use of other assets. A contributory asset charge is required when using an ‘excess earnings’ income approach to isolate the cash flows generated by the subject intangible asset from the contribution to those cash flows made by the other assets of the business (ie tangible assets, working capital, brands and other intangible assets). Contributory asset charges are hypothetical ‘rental’ charges for the use of those other assets.

aggregation for the group. The staff thinks that it would be difficult to prescribe which assets should be grouped together for valuation purposes. In some cases, the cash-generating unit in IAS 36 *Impairment of Assets* would be an appropriate unit of valuation. In IAS 36, a cash-generating unit is 'the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets'.

Distinguishing between the in-use valuation premise and value in use

33 As noted above, the fair value derived from an in-use valuation premise as defined in SFAS 157 is not the same as the value in use as defined in IAS 36. The former is a market-based measurement and relates to the price that market participants would pay for the asset; the latter is an entity-specific measurement based on an estimate of future cash flows that the entity expects to derive from the asset (or group of assets).

34 Question 17 of the *Fair Value Measurements* discussion paper asked whether it is clear that the in-use valuation premise is different from value in use in IAS 36. Most respondents thought that the conceptual distinction is clear, but some thought that the terms could be confusing and suggested alternatives:

a value in use by the potential acquirer

b value for continued existing use

c value in combination

d value as part of a group of assets

35 Some thought it is unnecessary to change the terms because valuation professionals are already familiar with the concept. Others thought it would be better to simply use the term 'highest and best use' without going into further detail, for the same reason.

36 Some noted that the term 'in-exchange' could be confusing because the in-use valuation premise also considers an exchange between market participants.

37 The staff thinks these terms are widely used in the valuation community, and are becoming more understood in the accounting community, and thinks changing the terminology now would be confusing.

Application to financial assets

38 Highest and best use is a concept that applies when an asset has more than one possible use. It considers whether market participants would put an asset to an alternative use with a higher value. Is this notion relevant for financial assets? Some might argue that financial assets have alternative uses in some cases, for example:

a as individual assets or as part of a portfolio,

b as an individual asset or as a 'strategic investment' to cement a relationship with a business partner or

c as an individual asset or as part of a package with a liability.

However, the staff has been unable to find any convincing examples in which financial assets have more than one use.

39 Do the notions of in-use and in-exchange valuation premises have any meaning for financial assets? Some read SFAS 157 to allow the in-use valuation premise for financial assets because it states that in-exchange valuation premise *might* pertain to financial assets. It is important to note that the valuation premise in SFAS 157 relates only to assets, not to liabilities (liabilities are discussed in the next section). As a result, the in-use valuation premise would **not** reflect any effects arising from holding financial assets together with liabilities.

40 The valuation premise recognises that the same asset can have a different fair value depending on whether the asset derives value on its own or in combination with other assets. For example, some would argue that an asset under the in-use valuation premise would have a higher value than the sum of the individual assets in-exchange if there are synergies or portfolio effects amongst the assets within the group. In other words, the

value of an asset in-use assumes that the asset can generate a higher return from its interaction with other assets than it could on its own.

41 The Board has tentatively decided that the unit of **account** for financial instruments is the individual instrument. Does that mean that the unit of **valuation** for a financial asset also is the individual instrument?

42 The objective of a fair value measurement is to arrive at the price at which a transaction would occur between market participants on the measurement date. Market participant buyers would be willing to pay different prices depending on their own entity-specific considerations, but such considerations would be limited by the fact that market participants are more willing to pay (or not pay) for some things than for others.

43 In Level 1 of the fair value hierarchy, a market price is unlikely to take into account any other assets (or liabilities) a particular entity has. The market price would not consider how the asset will be used within a particular entity's portfolio (unless all market participants had the same portfolio).

44 When there is not an observable market price, an entity tries to replicate what that price would have been on the measurement date, taking into consideration the factors market participants would consider when determining whether to trade at a particular price. Therefore, the fair value of a financial asset would not reflect the other assets held by one particular entity.

45 Some wonder whether this is different from the approach for non-financial assets. However, the staff thinks the approach is the same. An entity uses a market price to the extent that the price reflects the characteristics of the asset held, no matter what the asset is (ie if there is a price quoted in an active market for an identical asset that price must be used).

46 If there is not such a price available, the entity uses a valuation technique (or model) based on prices for a similar assets. For a tangible asset, this is likely to result in using the replacement cost approach, which uses a model reflecting the asset's condition and configuration within the business. While this might be true for assets such as tangible

assets (because tangible assets typically work with other assets to generate value), financial assets do not need other assets to generate value. As a result, financial assets can be measured on a standalone basis—if it is accepted that the market price would not consider how the asset will be used within a particular entity's portfolio.

47 Therefore, the staff thinks that the highest and best use and valuation premise concepts are not relevant for financial assets.

Application to liabilities

48 Some wonder whether the highest and best use (ie the use of the asset that is physically possible, legally permissible and financially feasible) and valuation premise concepts are relevant for liabilities.

49 Highest and best use considers whether market participants would put an asset an asset to an alternative use with a higher value. The staff cannot think of alternative uses for any kind of liability (financial liability, performance obligations, asset retirement obligations, pensions, insurance contracts, etc.). An entity might be able to change the cash flows from a liability by discharging it in different ways (eg fulfilment in the normal course of business, immediate settlement with the counterparty or immediate transfer to another party). However, in the staff's view, those are not alternative uses. As a result, the staff thinks the highest and best use concept is not relevant for liabilities. This is consistent with SFAS 157, which applies this concept only to assets.

50 The highest and best use is linked to the valuation premise. The valuation premise concept considers whether a liability is used in combination with other assets or liabilities (complementary assets or liabilities) or is used on its own. It also assumes that the complementary assets or liabilities are available to market participants.

51 A liability represents an obligation to provide assets or services to the counterparty. If an entity transfers an obligation to another party, the transferee now has the obligation to provide those assets or services. As a result, the valuation premise for a liability is always in-use and the question of an in-exchange valuation premise cannot arise. Thus, there is

no need to consider alternative valuation premises for a liability. This is consistent with SFAS 157, which applies this concept only to assets.

Staff recommendations

52 The staff recommends the following:

a a fair value measurement should consider whether market participants would maximise the value of an asset principally through its use in combination with other assets as a group (in-use) or on a standalone basis (in-exchange).

b the valuation premise and highest and best use concepts are not relevant for liabilities.

c the valuation premise and highest and best use concepts are not relevant for financial assets.

d the exposure draft should highlight the fact that an exit price considers a market participant's ability to generate economic benefit by using an asset or by selling it to a third party, but the definition of fair value is not the place to do this.

e the exposure draft should not change or introduce new terminology for the valuation premise (ie replacing the terms 'in-use' and 'in-exchange' with other terms).

Questions for the Board

53 **Does the Board agree that:**

a **the valuation premise and highest and best use concepts are not relevant for liabilities? If not, why not?**

b **a fair value measurement considers whether market participants would maximise the value of an asset (*and a liability, pending the Board's decision in paragraph 53a*) principally through its use in combination with other assets as a group (in-use) or on a standalone basis (in-exchange)? If not, why not?**

c **the valuation premise and highest and best use concepts are not relevant for financial assets? If not, why not?**

d **the valuation premise should not explicitly be reflected in the definition of fair value? If not, why not?**

e **the exposure draft should not change or introduce new terminology for the valuation premise (ie replacing the terms 'in-use' and 'in-exchange' with other terms)? If not, why not?**

Appendix: Manufacturing equipment measured at fair value

1. Unit of account in the relevant IFRS

Paragraph 9 of IAS 16 *Property, Plant and Equipment* states:

> This standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgment is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

In other words, the unit of account seems to be the individual asset or an aggregation of individually insignificant items.

2. The asset or liability (what is being measured)?

Entity A purchased manufacturing equipment on 24 December 20X7 for CU100. The manufacturing equipment is specialised, installed and configured for use by Entity A. Entity A installed the equipment in-house for CU10 (including labour at market rates and a profit margin).

Entity A uses the equipment to manufacture plastic motor vehicles. Entity A is the only manufacturer of plastic motor vehicles in the world.

The equipment is one week old and in 'as new' condition. It has a remaining useful life of 10 years, with no warranty.

3. Valuation premise (does the asset generate value by itself (in-exchange) or in combination with other assets (in-use)?)

Entity A is the only manufacturer of these plastic motor vehicles in the world. The equipment to make those vehicles was built especially for Entity A. No one else can use it.

However, the equipment is being used in Entity A's business. It generates (and maximises) value through its use with other assets in Entity A's business. A market participant buyer of the equipment would maximise the value of the equipment by using it in a similar process or configuration.

The manufacturing equipment does not generate maximum value on a standalone basis (in-exchange). This is because the equipment would be valued at scrap or a liquidation value if considered individually without complementary assets, and in this example it is clear that the equipment generates maximum value in combination with other assets.

Therefore, the valuation premise is in-use.

4. Highest and best use (is there another use for the asset?)

The equipment is specialised and cannot be used for any other purpose. There is no indication that a market participant buyer would apply the equipment in a different use.

Therefore, the current use is the highest and best use.

5. Exit transaction for the asset (who are the potential buyers for the asset or liability?)

Potential buyers for the specialised equipment are entities that have (or could obtain) complimentary assets and would use the specialised equipment in a similar production process or configuration.

Entity A can assume it is transacting with an entity like itself, and that would use the equipment in the same use.

6. Measurement (selecting valuation techniques, selecting inputs to valuation techniques using market participant assumptions)

There are three general valuation techniques to apply in the valuation:

Market approach	There is no observable market price to measure the fair value of the equipment in-use. Any available market prices are for standard (non-specialised) equipment on a standalone basis
Income approach	The equipment does not generate cash flows on its own
Cost approach	The entity can estimate the amount to replace the utility and service capacity of manufacturing equipment in a similar condition and configuration

Because the market approach and income approach cannot be used to measure the fair value of the equipment, Entity A uses the cost approach (specifically, the replacement cost approach).

The manufacturing equipment was bought 1 week ago for CU100, plus installation costs (at a market value) of CU10. Therefore, the fair value ('replacement cost new') on the acquisition date was CU110.

Fair value at acquisition	CU110.00
Less: Obsolescence*	CU 0.21
Equals: Depreciated replacement cost	CU109.79

* 110 ÷ (1 week / 520 weeks in 10 years) = 0.21; obsolescence in this example probably is physical because it is unlikely that functional, technological or external obsolescence has occurred in such a short period of time. See Paper #5 for a description of 'obsolescence'.

7. Attribute value to asset or liability at unit of account level

Not considered for this discussion.

8. Financial statement presentation and disclosure

Not considered for this discussion.