

# Business Valuation Monitor

Value creation perspectives for corporate executives and the investment community Volume 1, No. 2

## Entry versus Exit Price

### Entry Price in an Exit World

The trade-off between relevance and reliability in financial information is an ongoing debate. Fortunately, the fair value standard has enhanced the way value is measured. Navigating the hierarchical fair value path assures a clear and reliable route to accurate measurement of an exit price. The following article addresses the measurement approaches as outlined under Statement 157.

FASB Statement No. 157, *Fair Value Measurements*

By **David Dufendach**, Partner, Economic Advisory Services – Valuation Services Group

Prior to the issuance of Statement 157 in September 2006, guidance for fair value measurement was spread among many pronouncements that required or permitted such measurements. This led to differences in guidance and created inconsistencies in application that added to the complexity of GAAP. Statement 157 provides a framework that can be broadly applied; it is intended to increase consistency and comparability among fair value measurements used in financial reporting. Statement 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years.

The statement defines fair value as, “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” This definition retains certain characteristics of current practice while modifying other aspects. For example, the notion of an exchange price between market participants is retained, while the standard further defines the market as the principal or most advantageous market, and requires the exchange itself be categorized as “orderly” (i.e., not a forced sale).

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## Entry versus Exit Price (continued)

The new fair value standard also changes the way in which fair value is measured upon initial recognition as well as in subsequent periods. As noted, Statement 157 defines fair value as the price to sell an asset or transfer a liability and is identified as an exit price. Conversely, a transaction price represents the price paid to acquire an asset or received to assume a liability, and is, by definition, an entry price. While the statement recognizes that the entry and exit prices can often times be the same, it provides factors to consider when this may not be the case, such as in the following situations.

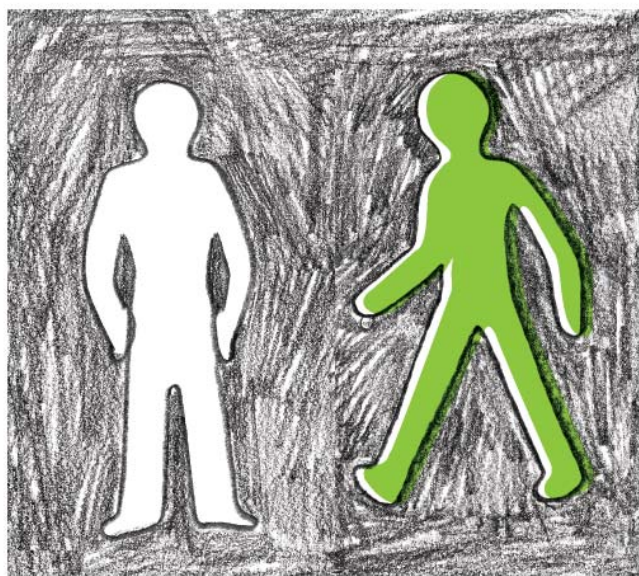
- The transaction is between related parties.
- The transaction occurs under duress, if the seller is forced to accept the price in the transaction.
- The unit of account represented by the transaction (i.e., the entry transaction) is different from the unit of account for the asset or liability measured at fair value (i.e., the exit transaction). This includes instances where the asset or liability measured is one of several elements of the transaction or when there are transaction costs.
- The market in which the reporting entity acquired the asset (or assumed the liability) is different from the principal or most advantageous market in which the entity would dispose of the asset (or liability).

With respect to implementation, the statement provides for two distinct transition approaches. The statement requires a limited form of retrospective transition for certain financial instruments including positions in active markets for which a blockage discount had been applied. The requirement applies to financial instruments initially measured at their transaction price in accordance with EITF 02-3, and hybrid instruments initially measured at their transaction price in accordance with guidance in Statement 155. For these instruments, the change is considered a change in accounting principle. It should be applied retroactively through the recognition of the cumulative impact of the change in principle in the opening balance of retained earnings in the period the statement is adopted.

The second transition approach should be applied prospectively to all other assets and liabilities subject to fair value measurements. The Financial Accounting Standards Board deems these changes in methods used to measure fair value as changes in estimates that should be accounted for accordingly in the period of adoption.

Disclosures related to subsequent fair value measurements vary, depending on whether such measurements are made on a recurring or nonrecurring basis. In either case, the disclosures are meant to provide financial statement users with insight into the relative reliability of the various measures, and thus broadly to assess the quality of earnings.

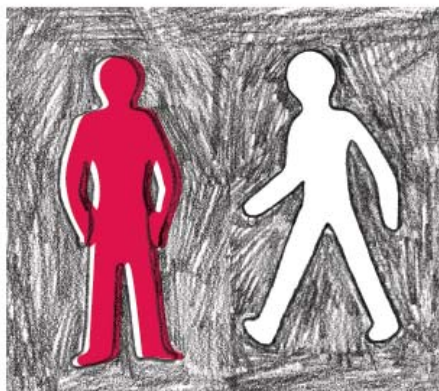
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## Entry versus Exit Price (continued)

For subsequent measurements occurring on a recurring basis, the statement requires a reconciliation of the beginning and ending balances for measurements that utilize significant unobservable inputs (or Level 3 inputs). Therefore, any asset or liability that was measured using such inputs at either the beginning or the end of the period should be included in the reconciliation. Further, the statement requires the reporting entity to disclose changes in unrealized gains and losses recognized in earnings for the period for assets and liabilities measured in Level 3 that are held at the reporting date.

For subsequent fair value measurements of assets and liabilities occurring on a nonrecurring basis (i.e., impaired assets), the statement requires disclosures of the amount of and the reason for the fair value measurement during the period. Because of their nonrecurring nature, the statement does not require reconciliations of beginning and ending balances for Level 3 assets or liabilities. Rather, for those assets or liabilities utilizing significant unobservable inputs in the fair value measurement, a description of the inputs and the information used to develop the inputs is required to be disclosed. •



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As a partner in the Valuations Services Group of Grant Thornton LLP, David Dufendach specializes in economic research, financial modeling and analysis in connection with the valuation of closely held businesses, intangible assets, intellectual property, financial instruments, derivatives, and related matters for purposes of financial statement reporting, litigation support (marriage dissolutions, lost-profits claims and others), corporate planning, acquisitions, sales, buy-sell agreements, income taxes, and estate planning and taxation.

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