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Valuation in the fair value era
Higher quality can help companies reduce risk and enhance shareholder value

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Executive summary

How companies establish the fair value of assets, liabilities, and equity for financial reporting purposes has been the subject of growing attention and major change since the turn of the millennium.

- In the 1990s, the accounting profession and investors started the transition from a historical cost accounting model to one incorporating certain fair value measurements without a clear definition of what constituted "fair value."
- Many egregious valuations of "In-Process Research and Development" assets in the late 1990s technology boom and bust period raised the antenna of the US Securities and Exchange Commission (SEC) to the practice of valuation and certain of its shortcomings.
- New accounting standards related to business combinations, goodwill, and asset impairment, to name a few, came into play in the early 2000s, leading to the current mixed-attribute accounting model.
- Massive US accounting scandals occurred almost simultaneously in this ever-changing environment, and the financial crises that followed—just when a principles-based standard on how to measure fair value was being put into play—gave momentum to legislation, rulemaking, and regulations.

This rapid evolution is now compelling public companies to provide higher quality fair value measurements than in the past—measurements and disclosures that are more consistent, supportable, and auditable.

Meeting these demands isn't easy. Fair value measurements can be complex and confounding, particularly when no market analog exists that can be used to help estimate the fair value of an entity's assets, liabilities, or equity. Meanwhile, regulators are scrutinizing financial statements. This attention is creating pressure that pushes throughout the corporate financial structure to an entity's management, board of directors, valuation specialists, and auditors, who can find themselves hopelessly at odds on certain issues.

A concern has been growing in recent years and is shared by many regulators, standard-setting bodies, and accounting and valuation professionals: Are financial statement preparers, their valuation advisers, and auditors equipped and qualified to engage in the various aspects of estimating and auditing fair value measurements in this new world? The increasing complexity of the financial marketplace adds to the difficulty of answering such a question. Educating the various stakeholders regarding key issues associated with fair value measurements is increasingly important. Higher quality, more consistent fair value measurements provided by company management to auditors should help address some of the issues that currently lead regulators and investors to challenge companies' financial reports. Widespread education about fair value should enhance the ability of auditors to audit certain fair value measurements, increase the stature of the valuation and audit professions, and influence the standard-setters' and regulators' future agendas. In addition, educating business leaders and company executives regarding valuation should help them understand the need for, and value of, qualified fair value specialists when developing fair value estimates, whether employed internally or engaged externally. Mitigating such regulatory and credibility risks can ultimately enhance shareholder value.

Fair value measurement—a growing imperative

Regulators, as well as accounting and valuation professionals, recognize that raising the quality and consistency of fair value measurements is necessary to improve the reliability of financial reporting for investors and to serve the public interest.

Actions and signals by US and other regulators, coupled with efforts undertaken by the accounting and valuation professions, highlight the growing focus on fair value measurements.

Securities regulators

In early 2014, SEC enforcement head Andrew Ceresney suggested that, with work on financial crisis-era litigation "virtually past," financial reporting and audit fraud are the "next frontier" for securities regulators.[1] These topics are also increasingly being discussed elsewhere in the world within national regulatory agencies that, like the SEC, are members of the International Organization of Securities Commissions (IOSCO).

Ceresney's prediction came on the heels of a string of SEC enforcement matters in 2012–2013 focusing on alleged flaws and fraud in connection with valuation issues.[2] The Commission brought action against businesses for infractions including overstating assets, defrauding

[1] http://blogs.wsj.com/cfo/2014/06/17/sec-official-financial-reporting-audit-fraud-are-next-frontier/?KEYWORDS=sec+and+audit+f
raud.

[2] http://www.bna.com/sec-turns-focus-to-valuation-issues/.

investors by inflating property valuations, and repurchasing stock at severely undervalued prices. Also in 2013, the SEC announced the formation of the Financial Reporting and Audit Task Force, a body dedicated to detecting fraudulent or improper financial reporting.[3]

The backdrop to this were remarks made in 2011 by Paul A. Beswick, then SEC deputy chief accountant, which brought the issue of valuation professional credentialing to the fore. Beswick said valuation professionals ". . . stand apart from other significant contributors in the financial reporting process for . . . their lack of a unified identity."[4] Noting that US professionals can gain credentials from several organizations, Beswick said the "fragmented nature of the profession creates an environment where expectation gaps can exist between valuators, management, and auditors, as well as standard-setters and regulators."[5]

Receiving less publicity are recent actions by the SEC staff, which have been referenced in SEC speeches. These actions are aimed at identifying the *potential* for material misstatements in financial reporting due to material weaknesses in internal controls over financial reporting, even when the identified material weaknesses *did not* result in a material misstatement. Fair value measurements fall squarely into the category of topics where significant internal controls are necessary. An emerging concern for regulators is that such controls are neither routinely being put into place and evaluated for their effectiveness by company management, nor flagged sufficiently in audits when a material weakness exists.

Audit regulators

The Public Company Accounting Oversight Board (PCAOB), a nonprofit corporation created by the Sarbanes-Oxley Act of 2002 and operating under the authority of the SEC, seeks to protect US investors and the public interest through oversight of public company audits. According to PCAOB Chairman James R. Doty, "The PCAOB and foreign audit regulators have identified compliance with auditing requirements related to fair value measurements as an area of continued concern."[6]

As Doty noted, growing concern regarding fair value measurements and disclosures extends beyond the United States. A 2013 member survey conducted by the International Forum of Independent Audit Regulators (IFIAR) found fair value measurement to be one of the highest inspection themes in audits of publicly listed companies.[7]

Further evidence of the growing importance of addressing the quality and consistency of fair value measurements in financial reporting came in December 2013 when Sir David Tweedie, Chairman of the International Valuation Standards Council (IVSC), was invited to join the PCAOB's Standing Advisory Group (SAG) for a three-year term.

In summer 2014, the PCAOB sought public comment on a Staff Consultation Paper concerning the board's standard-setting activities related to auditing accounting estimates and fair value measurements. As discussed in its paper, the PCAOB staff is currently considering developing "a single standard on auditing accounting estimates and fair value measurements for the Board to consider proposing, which would replace existing standards."[8] The paper suggests that such a standard "could provide a more comprehensive approach to auditing accounting estimates and fair value measurements that could promote more consistent auditor performance."[9]

Accounting standards

International Financial Reporting Standard 13 (IFRS 13) *Fair Value Measurement* provides guidance globally for measuring fair value and making disclosures concerning those measurements. Issued by the International Accounting Standards Board (IASB) [and in the US by the Financial Accounting Standards Board (FASB) as ASC 820] in 2011, *Fair Value Measurement* is a converged global standard.[10]

ASC 820/IFRS 13 establish a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs). Estimating fair value using significant Level 3 inputs is frequently inherently challenging due to the absence of market data.

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[3] http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975#.VB0GbhaKVEM.
[4] http://www.sec.gov/news/speech/2011/spch120511pab.htm.
[5] Ibid.
[6] http://pcaobus.org/News/Releases/Pages/08192014_Consultation_Paper.aspx.

[7] https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014_1.pdf.
[8] http://pcaobus.org/Standards/Documents/SCP_Auditing_Accounting_Estimates_Fair_Value_Measurements.pdf.
[9] Ibid.
[10] Statement of Financial Accounting Standards 157, Fair Value Measurements (FAS 157), issued by the FASB in September 2006, was subsequently revised and codified for US GAAP purposes as ASC 820, and simultaneously issued in a converged form as IFRS 13 by the IASB in May 2011.

The convergence of US and international standards for *Fair Value Measurement* was vitally important to creating an equivalent set of expectations globally. The growing interconnectedness of the global financial system, with public companies operating and filing in many countries other than their home jurisdiction, called for such a standard. A policy paper from the IVSC, discussed in the next section, addresses the importance of continuing this convergence of standards, expectations, and education globally.

Valuation profession initiatives

The private sector is engaged in valuation standard-setting and the development of the valuation profession in the United States and globally through various independent standard-setting and professional organizations. Such nonprofit organizations include the IVSC, the Appraisal Foundation (TAF), the American Institute of Certified Public Accountants (AICPA), and the American Society of Appraisers (ASA), among others.

With members and sponsors that include professional service providers, standard-setters, and valuation professional organizations, including those above, the IVSC is focused on developing high-quality international valuation standards and elevating the performance and stature of the valuation profession globally.

Over the last year or more, the IVSC, through its Professional Board, has issued three particularly important documents in relation to the items discussed in this article: a discussion paper, "Proposal to Develop International Professional Standards for Professional Valuers"; a policy paper, "Global Regulatory Convergence and the Valuation Profession"; and "A Guide to the Audit Process for Professional Valuers."

- The discussion paper identifies the need to develop and issue, in the public interest, a series of high-quality international standards on the education, development, assessment, and conduct of professional valuers. This significant project is now under way.[11]
- The policy paper discusses the importance of regulatory convergence relating to the global financial system and the valuation profession's vital role in producing the financial information that investors and other stakeholders use to make decisions in the financial markets.[12]
- The guide is intended to help equip valuation professionals who are providing valuations to assist reporting entities in statement preparation or entity auditors and their fair value specialists in auditing fair value measurements.[13]

Those in the valuation profession charged with enhancing valuation quality, particularly when it is in the public interest, need to continue to work together to enhance the public perception of the profession.

The challenges of meeting expectations

The considerable attention and growing urgency being given to improving the quality and consistency of fair value measurements in financial reporting are placing increasing demands on valuation professionals, auditors, and the organizations they serve. As the evolution from historical cost to a mixed-attribute model to, perhaps, ultimately full fair value accounting continues, an increasingly regulated auditing profession worldwide is racing to enhance its understanding of fair value and how to audit in a principles-based world.

The risk of material misstatement is an important principle driving SEC and PCAOB oversight, and fair value measurements are a prime potential source for such problems, whether through inadequate knowledge, error, or fraud. Accordingly, expectations regarding the quality and supportability of fair value measurements are higher than ever, requiring the comparatively small community of valuation professionals performing fair value analyses for publicly listed companies to double their efforts.

> While trained, capable valuation specialists are at work today in the financial reporting arena, their ranks are only a fraction of the size of the accounting and auditing communities.

In the US, a few among them have years of experience operating in the financial reporting arena and may carry credentials such as Chartered Financial Analyst®, Accredited Senior Appraiser of the American Society of Appraisers, or the Accredited in Business Valuation credential (issued by the AICPA).

[11] "Proposal to Develop International Professional Standards for Professional Valuers," IVSC Professional Board, November 7, 2013, http://www.ivsc.org/sites/default/files/Discussion%20Paper%20International%20Professional%20Standards%20final_0.pdf.

[12] "Global Regulatory Convergence and the Valuation Profession," IVSC Professional Board, November 7, 2013, http://www.ivsc.org/sites/default/files/Global%20Regulatory%20Convergence%20and%20the%20Valuation%20Profession%20final%20May%2014.pdf.

[13] "A Guide to the Audit Process for Professional Valuers," International Valuation Standards Council, January 2014, http://www.ivsc.org/sites/default/files/Valuers%20Guide%20to%20Audit%20%20-%20Released%20ED.pdf.

However, not infrequently senior executives of publicly listed companies engage people both internally and externally to perform fair value measurements who have no specific training or experience in the process. As a result, while the PCAOB and auditors are pressing for more consistent, strongly supported valuations, many of those doing the work are simply unaware of what fair value measurements should entail and are ill-equipped to provide them.

The valuation of financial instruments is a stark example of the phenomenon: The quantitative analysts at banks who develop fair value measurements for financial instruments typically are not valuation professionals, and the methods supporting such measurements are often hidden behind the cloak of "proprietary" practices. As a result, assessing the reasonableness of their fair value estimates can be extremely challenging for auditors and regulators—not to mention for bank senior executives who sign off on the financial reports containing those estimates.

Stress on the system—the fair value effect

For various reasons, when developing the concepts underpinning fair value measurements for financial reporting purposes, the accounting standard-setters focused primarily on frequently traded financial instruments. These fair value measurements, referred to as "Level 1" as mentioned earlier, largely involve quoted prices in active markets. "Level 2" measurements leverage market data from similar assets and indirectly observable data.

The complexities associated with estimating fair value are sometimes apparent in Level 2 measurements—for example, with thinly traded securities—but often occur in "Level 3" measurements. Such assets aren't bought and sold in the marketplace, there are no direct market analogs that can be used in the fair value measurement process, and there can be great difficulty in finding and supporting unobservable inputs. Methods to value some of these assets, liabilities, and equity instruments are also still evolving in many instances as the valuation profession tries to mimic how the marketplace would value such assets and liabilities *when there is no market for them!* It is easy to see why significant measurement uncertainty and inconsistency can arise in fair value measurements in this category, and why stresses can build up in the financial reporting system due to the difficulty in auditing such measurements.

Further, the accounting framework itself has caused additional stresses to arise. For example, consider the goodwill impairment test.[14] In this analysis, assume that the carrying value of an entity's reporting unit, which is not publicly traded, is $100 million. A fair value estimate of the reporting unit is required for comparison with the carrying value. From an accounting viewpoint, the goodwill is potentially impaired if the value is below $100 million; at $100 million or above it isn't. Fair value measurements can often only be estimated within a reasonable range, and sometimes the reasonable range for the fair value of the reporting unit can straddle the $100 million carrying value. The need for a point estimate in such a situation to comply with the accounting standard can create additional stresses that can reverberate throughout an organization, from auditors to valuation providers to executives who ultimately stand accountable for the conclusions.

Another increasing concern for regulators, investors, and other users of financial statements is the potential for management bias in fair value measurements, particularly in Level 3. With the heightened focus on fraudulent activity in recent years and the gradual understanding that many variables go into a fair value measurement—variables that are often provided by company management or based on "professional judgment" of the valuation professional employed by the company—heightened professional skepticism should be employed by auditors and their fair value specialists when auditing fair value measurements.

Historical practice norms can also create stresses in the system. For example, a "black box" mentality has frequently existed among the quantitative analysts in financial institutions performing the valuation of certain financial instruments, such as mortgage-backed securities. In today's world of transparency and supportability of fair value conclusions, this is a difficult issue to navigate for auditors and regulators. Even with a corporate willingness to provide information to support such fair value measurements, there is often a lack of understanding of, or an inability to easily produce, the level of information required in today's environment.

[14] For more on the role of valuation in goodwill impairments, please see two Deloitte white papers: "The goodwill impairment dilemma," available at http://deloitte.wsj.com/cfo/files/2013/02/goodwill_impairment_dilemma.pdf; and "Minimizing goodwill impairment differences globally," available at http://www2.deloitte.com/content/dam/Deloitte/us/Documents/finance/us-fas-minimizing-goodwill-impairment-differences-globally-110113.pdf.

Education—where vital interests converge

Regulators, accountants, auditors, and valuation specialists share the desire and need for greater clarity and understanding of fair value requirements and processes, interests often expressed as a call for standards. But standards are not a panacea. Unless those who perform, review, and use valuations are properly educated, the process will remain vulnerable to error and misapplication.

Accountants and auditors can better understand valuation and fair value. Many valuation providers can be more qualified for their roles and apply established valuation techniques more consistently. And government authorities can recognize the potential stresses—including unintended consequences—potentially resulting from the rules they impose on businesses. This convergence of interests offers significant common ground for these groups to strive for higher quality fair value measurement in financial reporting through appropriate standard-setting and regulatory actions.

These parties could benefit from education in various aspects of the valuation process, including:

- The professional knowledge, skills, values, ethics, and attitudes expected of a valuation professional operating in the financial reporting arena
- The complexity of the valuation exercise and its use of data from multiple sources, including company management
- An understanding of the life cycle of events and the responsibilities of the various parties involved when a fair value measurement is required and audited for financial reporting purposes
- An awareness of the limitations of the precision of a valuation when significant Level 3 inputs are involved
- The need for a supportable and auditable fair value work product that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs

Corporate stakeholders, particularly chief financial officers, controllers, and audit committees, can also benefit from increasing their understanding of the workings of valuation. By doing so, they can be better equipped to determine whether internal resources are qualified to perform valuations, assess the qualifications of external valuation providers, and establish appropriate internal controls required to help enterprise leaders recognize and provide quality valuation work to auditors.

The benefits of enhancing fair value quality

Scandals, crises, and growing accountability demands have triggered an unstoppable march toward higher quality fair value measurements, provided by better qualified valuation practitioners. The consistent application of valuation standards is an important foundation for achieving this goal. However, fully understanding the expectations of the environment within which fair value measurements are used is crucial for those wishing to be involved. Much has been achieved in the last decade toward improving the quality of fair value measurements. Much more, however, is required and must be strived for in the coming years.

All parties to the process can benefit from education about the important aspects of fair value in financial reporting. How each party’s interests and those of other stakeholders align, diverge, and should be reconciled is critical if those associated with fair value are to achieve greater credibility in the marketplace.

This is especially relevant for the senior executives of publicly traded companies who are responsible for tasking others in the organization to perform fair value measurements; providing information to external providers; providing such fair value measurements to their auditors, confident in the knowledge that they are reasonable and well supported; and ultimately signing off on those financial reports.

Importantly, by focusing attention on these issues, publicly listed companies with significant fair value requirements in their financial reporting can address audit and regulatory risks, enhance their credibility in the investment community, and, ultimately, increase their enterprises’ value in the marketplace.

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