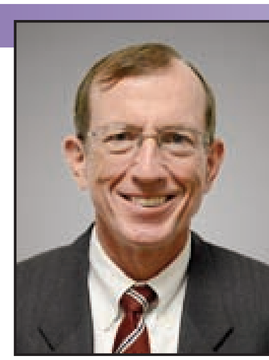
Advancing the Quality of Valuations for Financial Reporting



RAYMOND D. RATH,
ASA, CFA

Globalview Advisors
Irvine, CA
rrath@globalviewadvisors.com

People use both the terms *valuation industry* and also the *valuation profession.* There is some debate on whether valuation is simply a business or has truly reached the level of a profession. This article will provide historical background on the development of the business valuation profession and an overview of efforts to continue to advance the profession as it relates to valuations prepared for financial reporting purposes.

CONTRAST OF INDUSTRY AND PROFESSION

As a starting point, it might be helpful to contrast an *industry* and a *profession.* Key elements of Merriam-Webster.com definitions for each term follow:

- Industry- a group of businesses that provide a particular product or service
  - a distinct group of productive or profit-making enterprises
  - work devoted to the study of a particular subject or author

- Profession- a type of job that requires special education, training, or skill
  - a calling that requires specialized knowledge and often long and intensive academic preparation
  - a principal calling, vocation, or employment

The definition of industry includes the profit orientation that most of us associate with that term. Both industry and profession include focus or specialization, although the definition of profession clearly emphasizes the greater requirement for specialized knowledge and extended preparation. In assessing the definition for a profession from *www.Merriam-Webster.com,* I found a variety of elements that I expected to see either absent or, at a minimum, not well developed in the brief definition.

Additional research on the term "profession" suggests that many commentators view the elements of a profession in different ways. One source provided a list of milestones that suggest an occupation may be recognized as a profession. These include:

- Full-time occupation
- Specialized training
- Member organization
- Code of profession ethics
- Establishment of state licensing laws (more on this later)

HISTORICAL DEVELOPMENTS

One fair question is, "Why the concern about the structure of the valuation profession now?" Clearly, a progression is required to move from an occupation to a profession. The introduction of business valuation education in the early 1980s and certification of individuals performing business valuations by the American Society of Appraisers (ASA) were two of the earliest steps in the move of business valuation towards becoming a profession. The release of the Uniform Standards of Professional Appraisal Practice (USPAP) by The Appraisal Foundation (TAF) was another step in this progression.

USPAP was developed as a result of the savings and loan crisis of the late 1980s and early 1990s. Among the provisions of the Financial Institutions Reform Regulation and Enforcement Act of 1989 (FIRREA), The Appraisal Foundation was created with the intent to improve the quality of valuations – with a principal focus on real estate valuations. Poor quality real estate appraisals were one factor (among several) that contributed to significant financial difficulties for a variety of financial institutions and the economy overall. The economic difficulties due, in part, to poor appraisal quality are one example of the third-party impact of some valuations.

While business valuations are addressed by USPAP, absent client or valuation profession organization (VPO) requirements, most business valuations are not required to be prepared in compliance with USPAP. At the time of FIRREA, business valuations had limited third-party reliance risk and, therefore, most (almost all) business valuations are not required to be USPAP-compliant.

IPR&D VALUATIONS LEAD TO RESTATEMENTS OF FINANCIAL STATEMENTS OF PUBLIC COMPANIES

Approximately seven years after the enactment of FIRREA, the SEC, starting in 1998, raised concerns that corporate earnings were being managed by classifying a significant portion of the price of an acquired entity as in-process research and development (IPR&D). For accounting purposes,

Continued on next page

expert **TIP**

The valuation profession has made meaningful advances in the past 25 years. Despite this, deficiencies observed by regulatory parties suggest that further enhancements are required.

IPR&D had been immediately written off in a business combination.[1] IPR&D write-offs at the time of an acquisition result in improved future financial performance. Future earnings are increased as there is less amortization expense and reduced risk of future impairment charges. Also, future earnings may be "smoothed" as a result of these factors. Companies would also report increased return on assets as fewer assets are reported on the balance sheet. These factors could lead investors and other parties to obtain an inaccurate picture of the financial performance of entities. As indicated by then SEC Chief Accountant, Lynn Turner, "Abuses of the valuation of IPR&D also are expected. This trend of larger write-offs could undermine public confidence in financial statements and presents significant challenges for the accounting profession."

A study by Thomas D. Dowdell and Eric Press, "The Impact of SEC Scrutiny on Financial Statement Reporting of In-process Research and Development Expense" published in the *Journal of Accounting and Public Policy* in 2004, provides interesting insights on the magnitude of the problem. Dowdell and Press studied 98 restatements of valuations and financial statements in 1998 and 1999. For the initial valuation, IPR&D represented 66 percent of acquired assets. As a result of the revaluation, acquired IPR&D was lowered to 25 percent of acquired assets, resulting in a decrease in value of IPR&D of 62 percent. While values fall into ranges, the reported difference is large.

SEC comments on the problems with IPR&D valuations suggest a variety of factors leading to the mis-valuations. In 1998, Turner stated, [we] "identified circumstances where many of the facts appear at odds with the fair value assigned to that asset as part of the purchase price allocation." While many parties share responsibility, this comment raises the question of whether appropriate due diligence was performed by the appraiser. A variety of other factors— including limited accounting guidance and inadequate valuation models and procedures to develop appropriate assumptions— contributed as well.

This scrutiny of IPR&D valuations resulted in the release of valuation and accounting guidance including the American Institute of Certified Public Accountants (AICPA) Practice Aid, "Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries," released in 2001. This release provided helpful technical accounting and valuation guidance to improve the quality of IPR&D valuations. The release of IPR&D technical guidance represented another step forward for valuations. Given the more limited third-party impact of the IPR&D restatements, a dramatic change similar to the impact of FIRREA and USPAP on real estate valuations did not impact business appraisers.

SEC 2011 COMMENTS ON VALUATION PROFESSION

The genesis of this article and efforts to advance the valuation profession are reflected in the SEC Chief Accountant Paul Beswick's comments at the 2011 AICPA SEC Conference:

> Valuation professionals stand apart from other significant contributors in the financial reporting process for another reason, their lack of a unified identity. We accountants, for example, have a clearly defined professional identity. At last count, valuation professionals in the US can choose among five business valuation credentials available from four different organizations, each with its own set of criteria for attainment, *yet none of which is actually required to count oneself amongst the ranks of the profession.* (emphasis added)

The concerns briefly addressed in Beswick's comments have been the subject of much discussion by regulators, accounting firms and appraisers. There is general agreement that the valuation profession, at least as it relates to certain valuations prepared for financial reporting, needs to continue to advance.

Continued on next page

CLIENT ADVOCACY VS. THIRD-PARTY RELIANCE

An understanding of general purposes for valuations may help us understand the increased concerns about the current status of the business valuation profession. The purpose of business valuation services fall into three broad groupings. These include:

- Transactions
- Litigation
- Compliance – Tax and financial reporting

Transaction and litigation share certain characteristics that make them different from many valuation projects prepared for financial reporting. Transaction and litigation projects frequently involve competing parties that are often looking to maximize their proceeds from either a transaction or a court-determined settlement of a valuation dispute. Valuations for litigation are typically adversarial in nature. Valuations in a transaction setting typically involve parties with adverse economic interests. Based on my experience, many tax valuations also have characteristics of an adversarial valuation.

IMPACTS FROM INCREASED FINANCIAL REPORTING REQUIREMENTS FOR VALUATIONS

Concerns about IPR&D valuations decreased following the restatements of prior estimates and the recognition of improved guidance and increased scrutiny afforded these valuations. However, a variety of accounting changes added new requirements for additional fair value estimates that impact income statements and balance sheets of many public companies. As the SEC observations made clear, the impact on financial statements of fair value estimates can influence the decisions of equity and debt investors as well as suppliers, customers, and individuals making employment decisions.

The expanded requirements for fair value estimates in financial reporting have increased third-party reliance on valuation estimates. While transaction and litigation valuations often have limited third-party reliance, valuations for financial reporting purposes that involve public companies have broad third-party reliance. This increased third-party reliance combined with observations from regulatory bodies such as the Securities Exchange Commission and Public Company Accounting Oversight Board have led to current concerns about the current structure of the valuation profession.

The release of FAS 141 (now ASC 805), *Business Combinations,* and FAS 142 (now ASC 350), *Intangibles - Goodwill and Other,* in 2001 increased valuation requirements for certain elements of accounting for firms preparing financial statements. The release of FAS 123R (now ASC 718), *Share-Based Payment,* in 2004 further increased fair value requirements. FAS 157 (now ASC 820), *Fair Value Measurements,* clarified the general understanding of the valuation process and further increased the focus on fair value estimates.

In assessing the need for continued development of the business valuation profession (at least as it relates to financial reporting valuations), it is important to focus on key attributes of many business and intangible asset valuations. First, valuations are inherently based on future results. In some cases, past results are a clear indication of the future and valuations may be somewhat less challenging. However, many fair value estimates involve companies in dynamic industries where valuations can be quite challenging. As a recent example, Hewlett Packard's $10.3 billion acquisition of Autonomy in 2011 and subsequent $8.8 billion of write-offs associated with this acquisition is one high-profile example of the challenges in valuations. While not an example of a compliance-related valuation failure, this example highlights difficulties in measuring value.

As noted previously, education and certification efforts and the release of USPAP represented early steps to advance the practice of performing valuations. The release of ASC 820, *Fair Value Measurements,* also represents an advance for the profession, as does the subsequent release of an updated version of ASC 820 and virtually identical guidance by the International Accounting Standards Board with the release of its fair value guidance, IFRS 13, *Fair Value Measurements.* The release of the International Valuation Standards (IVS) by the International Valuation Standards Council (IVSC) should contribute to more uniform standards globally.[2]

RELEASES OF TECHNICAL VALUATION GUIDANCE

Releases of technical guidance by The Appraisal Foundation and the AICPA have helped advance the application of methodologies and development of assumptions used in business and intangible asset valuations. Reduced divergence in valuation practice due to expanded technical guidance advances the profession. Notable technical guidance includes:

The Appraisal Foundation

- "The Identification of Contributory Assets and the Calculation of Economic Rents," issued May 31, 2010
- "The Valuation of Customer-Related Assets," exposure draft dated December 5, 2013
- "The Measurement and Application of Market Participant Acquisition Premiums," discussion draft dated April 16, 2013
- Guidance on valuation of contingent consideration is currently being developed.

American Institute of Certified Public Accountants

- *Assets Acquired to Be Used in Research and Development Activities,* © 2013
- *Valuation of Privately-Held-Company Equity Securities Issued as Compensation,* © 2013

Continued on next page

- Guidance on the valuation of investments held by investment firms such as private equity and venture capital funds is current being developed.

While these guides demonstrate efforts to move the technical aspects of valuation practice forward, significant additional work is required. A means to insure competent, independent valuations are being performed is required. One question is whether these valuation quality initiatives can be achieved by current participants in the world of business valuation or whether external parties such as federal or state government entities will assume the responsibility. In the case of real estate valuations, state licensing bodies have assumed key regulatory roles due to the requirements of FIRREA. Whether government licensing of business valuation practice becomes a future reality may be determined by the current efforts to advance the profession.

VALUATION QUALITY

Valuation quality can be impacted by factors including:

- Advocacy – Lack of independence and/or objectivity
- Insufficient technical competence
  - Inadequate knowledge of guidance impacting valuation (accounting guidance as an example)
  - Insufficient technical skills
- Negligence
  - Inadequate valuation procedures (ties to lack of competence)
  - Inadequate quality control

At present, there have been limited efforts to address quality concerns. Many financial reporting valuations are reviewed by management and auditors. These valuations may also be evaluated by the SEC. The PCAOB frequently assesses the review of a valuation performed by an audit firm. However, there have not been substantive changes to the profession's structure specific to the quality of valuation estimates. Valuations can and are performed by individuals with no professional credentials or specialized education and no requirement to abide by formal standards or code of ethics.

Additional development of the profession's infrastructure as it relates to valuations prepared for the public capital markets is essential. Several possible areas include:

- Certification and reaccreditation
- Professional standards
- Quality review and oversight/ disciplinary activities

While complexities exist, a plan for outlining priorities and timing is being developed. The valuation profession must rise to the occasion or it risks having its professional activities assumed by others outside the profession.

STRUCTURE OF THE VALUATION PROFESSION

In assessing plans to advance the profession, a brief review of the current valuation environment is informative. Besides the users of financial statements, there are a variety of parties concerned with fair value estimates in financial statements. These include regulatory bodies, Valuation Standard Setters (VSS) and Valuation Professional Organizations (VPO).

Regulatory bodies include the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB). The SEC is an agency of the United States federal government. It holds primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other activities and organizations, including the electronic securities markets in the United States. In reviewing filings, members of the SEC staff often raise questions pertaining to valuation estimates impacting a filing.

The PCAOB is a private-sector, nonprofit corporation created to oversee the audits of public companies and other issuers in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB can be described as an organization that "audits" the auditors. PCAOB personnel regularly perform inspections of audit procedures and issue inspection reports that are made publicly available. The depth of documentation of auditors' reviews of valuations is one area noted in inspection reports as requiring enhanced procedures.

Valuation Standard Setters include the International Valuation Standards Council (IVSC) and The Appraisal Foundation. The IVSC is focused on providing global guidance through its standards and professional boards. The Appraisal Foundation is focused on the United States through its Appraisal Standards Board (ASB), Appraiser Qualifications Board (AQB), and recently formed Appraisal Practices Board (APB). Additionally, VPOs typically develop their own standards and/or adopt standards established by the VSS. As an example, the ASA has developed its own Business Valuation Standards and also requires its members to adhere to USPAP.

Valuation Professional Organizations include multi-disciplinary bodies such as the ASA and Royal Institute of Chartered Surveyors (RICS) as well as organizations that provide business valuation credentials and have developed their own standards. These include the AICPA; the National Association of Certified Valuators and Analysts (NACVA); the Institute of Business Appraisers (IBA); the International Association of Consultants, Valuators and Analysts (IACVA); and the Canadian Institute of Chartered Business Valuators (CICBV).

ELEMENTS OF PROFESSIONAL INFRASTRUCTURE REQUIRED

Parties with a broader view of the quality of financial reporting valuations include the SEC and PCAOB as well as valuation professionals performing valuation reviews at audit firms. The experiences of these groups suggest a need for improvements in

Continued on next page

the quality of valuations. An enhanced professional infrastructure would lead to improvements in valuation quality. Individuals assessing this need have noted potential areas for improvement including:

- Possible Accreditation/Certification and Recertification for Financial Reporting Practitioners– Potential education, experience, and recertification requirements. Recertification requirements could include continuing education and possibly retesting.
- Professional Standards (guidance) addressing professional behavior and ethics. Also, possible technical performance standards and accompanying guidance.
- Quality Review and Oversight/Disciplinary Process - Creation of procedures and infrastructure to increase quality and confidence in financial reporting valuation. Potential for institution of periodic practice reviews. Degree of practice reviews to be determined, but should stress the importance of a rigorous review to enhance valuation quality. Assessment of consequence for failure to meet minimum requirements. "Buy in" required by regulators, valuation standard setters, valuation professional organizations, valuation firms, and buyers of valuation services.

GENERAL FRAMEWORK FOR ADVANCING THE VALUATION PROFESSION

The current efforts to advance the valuation profession for financial reporting include regulators, VSS, VPO, accounting firms, and firms and individuals performing valuations. Users are not currently included in the bodies addressing the needs for the valuation profession. The needs of users of financial statements as related to valuations are being addressed by the Financial Accounting Standards Board (FASB) and the Private Company Council (PCC).

Currently, individuals representing the VSSs and the VPOs have developed several working groups to focus on key elements needed to move the valuation profession forward. Additionally, representatives of a variety of accounting firms are involved through an oversight role. An overview of each of the broad areas of focus (work-streams) follows.

Governance and Coordination Work-stream (I)

The tasks and objectives of this work-stream include:

- coordinate all work-streams
- develop an overall structure including functions to be addressed by existing VSS and VPOs
- the possible need for a newly created self-regulatory organization to handle certain functions and the potential outsourcing of other functions
- address key issues including communications with regulatory bodies, possible intellectual property ownership, and links among organizations.

Qualifications (Education/ Examination) Work-stream (II)

Objectives of this work-stream include:

- developing requirements or recommendations for base knowledge
- initial testing and ongoing continuing education for firms performing valuations for financial reporting
- recommend whether a separate "credential" for providing public interest valuation services is needed
- assess existing resources including testing resources, continuing education material, and means of tracking member compliance.

Performance Standards Work-stream (III)

Objectives include:

- determine efforts needed to support a valuation opinion (i.e., procedures on client projections, other)
- develop an approach to the standards (i.e., standards vs. guidance)
- ability to leverage existing organizations such as TAF or other accounting standard-setting bodies.

Quality Control Work-stream (IV)

Objectives include:

- develop framework for quality reviews of valuation firms / individual practitioners.

Key issues that require consideration include funding of review function, frequency of review, responsible party/ source of communication, interaction with regulators, disciplinary process and outcomes, and other legal matters.

CONCLUSION

The valuation profession has made meaningful advances in the past 25 years. Despite this, deficiencies observed by regulatory parties suggest that further enhancements are required. While the future status of the valuation profession is yet to be determined, an enhanced professional infrastructure for those performing public interest valuations (i.e., valuations for financial reporting) is generally viewed as necessary.

Professional infrastructure needs for other valuation purposes such as litigation and transaction support are typically driven by the market and changes may not be necessary to protect the public interest. An alternative to a structure developed by those within the profession is government licensing of individuals and firms providing business, intangible, and other valuations. In the event the profession is unable to achieve the necessary enhancements required, government licensing akin to that in place for real estate appraisers is a possible alternative. Another possible alternative could be the "roll-back" of fair value requirements for financial reporting.

[1] The accounting treatment of acquired in-process research and development changed with the release of FAS 141R in 2007. While IPR&D was previously expensed at the time of acquisitions, FAS 141R required capitalization of IPR&D at acquisition. IPR&D would then be either amortized or written off depending on the success of the IPR&D project.

[2] The International Valuation Standards Council issued *Establishing and Developing a Valuation Professional Organisation* in 2013. This guide was largely based on *Establishing and Developing a Professional Accountancy Body*, published by the International Federation of Accountants in December 2010. This IVSC guide provides detailed insights on structures that would advance the valuation profession.