

# *Valuations in Financial Reporting*

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# *Disclaimer*

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# *Agenda*

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- **Financial Reporting and Valuation Landscape**
- **The Role of the SEC Staff**
- **The Role of Valuation Professionals**
- **Valuation Infrastructure**
- **How Valuation Professionals Can Help**



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# *FINANCIAL REPORTING AND VALUATION LANDSCAPE*



# *Financial Reporting and Valuation Landscape*

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- Accounting standards require more use of fair value as measurement objective
- Fair value conclusions must meet U.S. valuation guidance/definitions first before valuation theory / principles / various standards
- Understanding of related U.S. GAAP guidance is key; however, these standards and guidance are evolving
- FASB to issue Fair Value Measurements standard
- International convergence and valuation matters getting more attention



# *Fair Value Measurements*

## *Key Definitions\**

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- Fair value
  - “the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date”*
- Market participant
  - buyers and sellers in the principal (most advantageous) market for the asset or liability
- Principal (most advantageous) market
  - Principal market is the market in which the reporting entity would sell / transfer the asset / liability with the greatest volume and level of activity
  - If there are multiple markets and no principal market, assume the most advantageous market that maximizes amount received for assets or minimized amount paid for liabilities

\* based on guidance set forth in March 2006 Fair Value Measurements draft standard



# *Fair Value Measurements*

## *Key Attributes\**

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- For assets, assume the highest and best use
  - from the perspective of some (two or more) market participants
  - In-use or in-exchange without regard to the intended use of the asset by the reporting entity
- For liabilities, assume market participants with comparable credit standing

\* based on guidance set forth in March 2006 Fair Value Measurements draft standard



# *Fair Value Measurements*

## *Key Attributes\**

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- Maximize the use of observable market inputs and minimize the use of unobservable market inputs
- Exclude factors specific to the reporting entity if market participants would use different assumptions (no entity-specific synergies)
- Does not require an actual transaction or that a market exist
- Based on information that is current at the measurement date
- Transaction price (entry price) may not reflect fair value (exit price)

\* based on guidance set forth in March 2006 Fair Value Measurements draft standard



# *Fair Value and Financial Reporting*

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*The use of fair value is intended to increase:*

- **Relevance of reported numbers**
  - Based on current economic conditions
  - Reflects opportunity cost of holding asset
  - More timely – don't have to wait for realization
- **Comparability**
  - Not dependent on how the entity obtained the asset
  - Reflects relative performance
- **Reliability**
  - Could be more reliable than estimates currently used (depreciation, bad debt allowance)



# *Some Concerns with Fair Value*

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- **Relevance**
  - May not reflect management intent
  - Changes in entity's credit quality affects value
  - May represent “hypothetical” transactions instead of real ones
- **Reliability**
  - Requires judgment
  - Not verifiable
  - Auditability
  - Lack of expertise
- **Difficulty / Expense**
- **Second Guessing**



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# *SEC STAFF AND VALUATIONS*



# *The SEC Staff and Valuations*

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- **Fairly new area for the SEC Staff**
  - Recent in-house expertise
- **Defining role to be played by the SEC staff and that of other financial reporting players**
- **Keeping an open dialogue with Valuation Professionals**
- **Coordination among SEC, FASB, PCAOB and others regarding emerging issues**



# *The SEC Staff and Valuations*

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## *Office of the Chief Accountant*

- **Registrant Consultations**
  - Appropriate methodologies
  - Valuation factors to consider
  - Review overall reasonability of numbers given facts and circumstances
  - Coordination among SEC staff, registrant, auditors and valuation professionals
- **Oversight**
  - Valuation principles and relevant financial reporting guidance to consider
  - No comment on “emerging issues”



# *The SEC and Valuations*

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## *Division of Corporate Finance Reviews*

- Committed to taking valuation issues seriously
- Look for / ask questions to ensure:
  - Compliance with GAAP
  - Overall fair value conclusions and related key assumptions make sense based upon facts and circumstances
  - Appropriate valuation methodologies applied
  - Sufficient disclosures for investors to make their investment decisions
- May seek advice from OCA as deemed necessary



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# *THE ROLE OF VALUATION PROFESSIONALS*



# *The Role of Valuation Professionals*

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***Add confidence, objectivity and reliability to fair value estimates***

- **Unbiased, neutral, independent valuations**
- **Valuations consistent with GAAP**
- **Help identify appropriate inputs and methods**
- **Identify models and methodologies to value hard-to-value items**
- **Test and verify input data**
- **Help auditors verify management estimates**



# *The Role of Valuation Professionals*

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## *Interface with the Registrant*

- **Financial statements are the responsibility of management**
  - **Management certification**
- **Management must establish an accounting and financial reporting process for determining fair value measurements and disclosures**
- **However, valuation professionals should not just accept management's unreasonable estimates or inputs as being market participant assumptions**



# *The Role of Valuation Professionals*

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## *Interface with the Auditor*

- **The auditor must (SAS 73 and SAS 101)**
  - obtain sufficient competent audit evidence to provide reasonable assurance that fair value measure in conformity with GAAP
  - obtain understanding of methods and assumptions used by valuation professional
  - make appropriate tests of data provided to valuation professional
- **The valuation professional must**
  - understand role and reliance being placed on them
  - provide appropriate information to auditor to facilitate auditor review requirements
  - avoid relying on auditor to “adjust” fair value results to meet GAAP



# *The Role of Valuation Professionals*

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## *Reporting and Scope Issues*

- Reports should be able to stand on their own
- Instances of where follow-up required because of “holes” in the reports
- Show/explain logic of all calculations
- “Indication of Value” / Calculation Analysis not appropriate as primary support
- Scope limitations may cause issues
- Valuation professionals should understand how work is being used
  - “Expert” language in SEC filings



# *Specific Valuation Issues*

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- Asset values may be materially misstated if other identifiable intangible assets existed but not valued
- Materiality assessment cannot be made without analysis
- Immaterial items can collectively misstate goodwill
- Assets to be valued should include those used defensively
- Should not have different values for different purposes
- Complementary assets can only be recognized as a single asset apart from goodwill if assets have similar useful lives
- Customer relationships being undervalued
- Reduction of value due to restriction on useful life
- Step 1 versus Step 2 of goodwill impairment test



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# *VALUATION INFRASTRUCTURE*



# *Valuation Infrastructure*

## *Inadequate infrastructure to support valuations for financial reporting purposes*

- **Inconsistencies in valuation approaches and assumptions**
  - No mechanism to resolve practice issues
- **Quality issues with valuations used for financial reporting purposes**
- **Lack of US GAAP equivalent for valuations**
- **Lack of US GAAS equivalent for conduct and reporting, peer reviews**
- **Concerns over biased valuations / opinion shopping**
- **Inconsistent approaches by auditors**



# *Valuation Infrastructure*

<i>Infrastructure Component</i>	<i>Accounting Profession</i>	<i>Valuation Profession</i>
<i>Professional Standards and Practice Matters</i>	<i>Single accreditation and set of standards applied to ALL practitioners</i>	<ul style="list-style-type: none"><li>• <i>Multiple accreditations and standards</i></li><li>• <i>Some practitioners have no standards to follow if not accredited</i></li></ul>
<i>Formal Quality Review process applied to all practitioners</i>	<i>PCAOB reviews</i>	<i>?</i>



# *Valuation Infrastructure*

<i>Infrastructure Component</i>	<i>Accounting Profession</i>	<i>Valuation Profession</i>
<i>Formal Disciplinary Mechanism that is applied equally to all practitioners</i>	<ul style="list-style-type: none"> <li>• PCAOB</li> <li>• State Licensing Boards</li> <li>• SEC</li> </ul>	?
<i>Formal mechanism to resolve differences/ practice matters that is applicable to all practitioners</i>	<ul style="list-style-type: none"> <li>• EITF (Formal)</li> <li>• SEC/FASB Consultation (Informal)</li> </ul>	?
<i>Legal Liability</i>	<ul style="list-style-type: none"> <li>• To all users of financial statements</li> <li>• Expertized</li> </ul>	<ul style="list-style-type: none"> <li>• To client and identified readers only (unless expertized – very rare)</li> </ul>



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***HOW VALUATION  
PROFESSIONALS CAN HELP***



# *How Can Valuation Professionals Help*

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- **Help auditors to better understand models, inputs, etc.**
- **Help management to better understand the uses and limitations of valuations**
- **Identify diversity in practice**
  - **Inconsistency in assumptions being used**
  - **Differences in assets being valued in similar transactions**



# *How Can Valuation Professionals Help*

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- **Provide input on standards under development**
  - What a valuation can accomplish and what it cannot
- **Help to identify**
  - Accounting definitions that are different from accepted valuation industry definitions
  - Guidance that is unclear
  - Areas where additional guidance is needed
- **Continued involvement**
  - Professional groups
  - Dialogue with auditors, registrants, regulators



# QUESTIONS AND ANSWERS

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