

# Assessment of the Current Professional Infrastructure Governing Fair Value Quality

## Progress Report

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# Table of Contents

Executive Summary.....	2
Problem Identification .....	3
Project Approach .....	4
Performance Requirements.....	5
Qualifications .....	6
Quality Control.....	8
Conclusion.....	11

## Executive Summary

Within the past several years, public statements by U.S. capital market regulators have called into question whether some of the individuals conducting fair value measurement estimates for financial reporting purposes have the requisite training, qualifications, experience, and expertise to perform this type of work. The SEC has expressed a desire that the various stakeholders in the valuation profession coordinate their efforts to establish rigorous and uniform qualifications, training, accreditation, and oversight of individuals conducting fair value measurements for financial reporting purposes for SEC-registered U.S. public companies.

In response to these regulatory concerns, several not-for-profit valuation professional organizations (VPOs), non-membership organizations, and others have worked together to focus on the issues facing the valuation profession and how to address them. Working groups spent a considerable amount of time discussing the key elements of a VPO infrastructure that would govern individuals conducting fair value measurements for U.S. public company financial reporting purposes.

The results of this effort include the development and implementation of a credential to be issued by approved VPOs for individuals who perform fair value measurements for financial reporting purposes for SEC-registered U.S. public companies. This credentialing program includes submission to an ongoing, engagement level quality review process and compliance with newly established performance requirements. The goal of this credentialing program is intended to ensure consistency and transparency in the fair value measurement process, which will ultimately result in a positive impact on the audit process by enabling auditors to have more confidence in the work performed by these credentialed specialists.

## Problem Identification

During the last 15 years, the global accounting model has increasingly gravitated towards the use of fair value as the basis for reporting values of certain assets and liabilities. Estimating these fair value measurements often involves the use of sophisticated financial models, various valuation approaches and analytical assumptions, and professional judgment.

Within the past several years, U.S. capital market regulators have questioned the training, qualifications, experience, and expertise of some of the individuals conducting fair value measurement estimates for SEC registrants through public statements. In addition, these regulators have highlighted that individuals conducting fair value measurement estimates are not currently required to adhere to a consistent set of professional, technical, and ethical standards related to the performance of this type of work. In response, a number of ad hoc groups, roundtables, and discussion forums have formed to discuss ways to address the various issues and concerns. Despite these efforts, insufficient progress has been achieved.

In early 2014, collaboration among numerous groups, including not-for-profit valuation professional organizations (VPOs), non-membership organizations, and others, resulted in the formation of a Task Force, which includes several “work-stream” groups focused on relevant aspects of this issue. This paper outlines the approaches and the conclusions developed by each work-stream.

The Task Force has addressed the four major issues described below:

- 1) Some individuals operating in the U.S. are conducting fair value measurements that are not analytically consistent, conceptually appropriate, technically sound, or properly supported. Individuals conducting these engagements at times lack the necessary training, qualifications, expertise, and experience to perform these valuation assignments in a manner consistent with existing valuation standards and best practices. As a result, the work of these individuals is creating an overall negative perception of professionals providing fair value measurements.
- 2) The SEC has expressed a desire that the various stakeholders in the valuation profession collaborate and coordinate their efforts to establish the qualifications, training, accreditation, and oversight of individuals conducting fair value measurements.
- 3) The valuation profession in the U.S. is fragmented and involves a variety of not-for-profit and for-profit organizations that have differing membership constituents as well as varying requirements regarding member qualifications, experience, training, accreditation, and reaccreditation. In addition, there are individuals that publicly profess themselves to be valuation experts that are not members of any recognized VPO and are not subject to any professional, ethical, or technical standards.<sup>1</sup>
- 4) This situation has resulted in the public perception that the valuation profession is not an actual profession similar in character to the legal, medical, and accounting professions. The fragmented

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<sup>1</sup> Absent a regulatory mandate or encouragement, management and other individuals that publicly hold themselves out as valuation experts who are not members of a VPO are not required to adhere to professional or technical standards, ethical requirements, or accreditation or reaccreditation requirements. Consequently, the regulation of these individuals is not within the scope of this initiative.

nature of the valuation profession, the ability of unqualified and uncertified individuals to practice, as well as the array of valuation credentials and designations has left government regulators, corporate entities, investors, and the general public in a state of confusion regarding the qualifications, expertise, experience, integrity, and credibility of individuals conducting fair value measurements. This situation has led to some concern in the reliability of the information provided by the U.S. financial reporting system.

## Project Approach

The Task Force determined that the key elements of a VPO infrastructure that would govern individuals conducting fair value measurements for U.S. financial reporting purposes should include the following:

- Professional Qualifications
- Accreditation and Reaccreditation
- Performance Requirements
- Quality Review and Discipline
- Ethics and Enforcement

The Task Force formed four work-streams designed to address VPO governance and operational infrastructure issues relevant to fair value measurements activities. Those work-streams and a description of their missions are as follows:

**Governance and Coordination** - Address a variety of governance and infrastructure issues, including the role, functions, and structure of existing VPOs. The Task Force decided that the Governance and Coordination work-stream would provide overall coordination of the project.

**Performance Requirements** - Build a process to develop a Mandatory Performance Framework (i.e., requirements that will govern the quality of work needed to support fair value measurement conclusions and opinions) to be applied by all fair value credential holders as defined by the Qualifications work-stream.

**Qualifications** - Develop requirements or recommendations for base knowledge, initial testing, and ongoing continuing education. Recommend whether a separate “credential” for providing fair value measurements is needed.

**Quality Control** - Develop a framework for quality reviews of individual practitioners by existing VPOs. Among the issues to consider are frequency of review, sources of communication, disciplinary processes and outcomes, and legal matters.

The remainder of this paper outlines the key issues considered and recommended actions.

## Performance Requirements

U.S. accounting standards have evolved to a “mixed model”, combining aspects of historical cost measurement attributes with fair value measurements attributes, and the SEC and the Public Company Accounting Oversight Board (PCAOB) expect financial statement preparers and their advisors to provide more consistent, supportable, and auditable fair value measurements.

The valuation profession has responded to this by developing technical standards and guidance, essentially addressing the “how to” question. Further, VPOs have increased their focus on providing training, accreditation, technical guidance, and frameworks for ethical conduct, essentially addressing the “who is to do” question.

One area, however, where gaps in guidance are believed to still exist relates to performance (i.e. addressing the “how much to do” question). Various terms have been used to describe this topic, such as “level of rigor,” “depth of analysis,” “scope of work,” “level of due diligence,” “extent of documentation,” or “extent of investigation.”

The following definitions are proposed to differentiate “professional standards” and “technical standards” from “performance requirements”:

**Professional Standards:** *Standards which encourage professional behavior (e.g., codes of ethics, codes of conduct, acting competently, transparency, etc.). Alternatively, these are standards that define a professional: ethical, independent, objective, requisite skills, educated, experienced, tested, trained, and credentialed/licensed. Professional standards focus on characteristics of the individual professional and the conduct of their behavior.*

**Technical Standards:** *Standards that address what type of work must be done to prepare a “professional” work product. These standards address the technical “correctness” of the work product, by considering appropriate input factors, methods/techniques, and reconciling conditions. Both mandatory standards and voluntary guidance have been developed around technical issues in valuation in general and to a lesser extent around fair value measurements.*

**Performance Requirements:** *Requirements that cover how much work should be performed in order to prepare a “professional” work product. Performance requirements address scope of work, level of rigor, extent of due diligence and analysis, consideration of contrary evidence, and documentation in both the report and the work papers. Alternatively, performance requirements reflect the extent to which the professionals perform their work in terms of depth of analysis and documentation.*

The Performance Requirements work-stream’s approach to addressing the gap in performance-related guidance is to develop performance requirements in the areas where such standards are needed and refer to the existing guidance in the areas where such guidance already exists (e.g., IPR&D guide provides guidance on PFI). In order to set the stage for such a set of performance requirements, this work-stream has built a process to develop a Mandatory Performance Framework (“Framework”) to be applied by all fair value credential holders.

Once the Framework is drafted and has undergone thorough review by the work-stream and other key stakeholders, it will be opened up to the public for comment. Feedback from public comment will be synthesized and incorporated into the finalized Framework, at which point the Framework will be published and made available to the public.

## Qualifications

Fair value measurements may be performed by management or third party firms such as CPA firms, pricing services, boutique valuation firms, private equity/venture capital firms, or investment banks. Currently, there is no credential that is designed exclusively for professionals who provide fair value measurements for U.S. public companies for financial reporting purposes.

In consideration of these factors, the Qualifications work-stream's recommendation is the development and implementation of a credential to be issued by approved VPOs for individuals who perform fair value measurements for financial reporting purposes for SEC-registered U.S. public companies. The initial audience to be considered for credentialing will be third party valuation preparers who perform fair value measurements for businesses and intangible assets. Regulation of management and other individuals that publicly hold themselves out as valuation experts who are not members of a VPO is not within the initial scope of this initiative.

In order to implement the new fair value credential, the Qualifications work-stream examined two issues:

- i. Qualifications to obtain the fair value credential; and
- ii. The body of knowledge/required competencies of individuals who seek to obtain the fair value credential.

## Requirements

The qualifications process will build upon existing VPO valuation and credentialing programs. In order to demonstrate that the fair value candidate has an essential understanding of valuation principles and concepts, the individual must attain the credential through one of the approved VPOs and adhere to the ethical and membership requirements of that VPO. They must also meet the minimum combination of experience and education and meet the assessment requirements as outlined by each approved VPO.

The individual will be subject to all technical and professional standards of that organization. Each approved VPO will be responsible for ensuring that fair value credential holders meet and maintain the required professional and technical competency requirements.

## Minimum Experience Requirements

The individual must have 3,000 hours of fair value measurement experience related to valuations of businesses and intangible assets over the five years prior to application for the fair value credential. Experience must be attested to by a supervisor, except for individuals such as senior leadership with demonstrated experience related to valuations of businesses and intangible assets.

### Experience Documentation:

Documentation will be required to meet the experience requirements indicated above. Options for documentation of experience include:

- a) Self-attestation or attestation with partner/peer recommendation
- b) Resume submission
- c) Detailed submission of hours worked in fair value measurements over the last five years

A combination of the first two options might be most viable (e.g. submission of a resume with an attestation statement along with a partner/peer recommendation attesting to hours of experience). The third option, submission of hours worked, is not always possible depending upon the years of employment and availability of record keeping to the fair value credential candidate; however, this option may be feasible for individuals with tenure.

### **Education Requirements**

Fair value credential candidates will be required to undertake education/training relating to the fair value measurement Body of Knowledge which will be delivered by each of the approved VPOs.

The Body of Knowledge has been developed to identify the competencies required to obtain the fair value credential. This knowledge focuses on the following:

- The accounting and regulatory environment as it relates to fair value measurements;
- Fair value technical guidance related to public interest valuations;
- Auditing requirements as they relate to fair value measurements and the use of the valuation report in the audit process; and
- Mandatory performance framework requirements.

Experienced Entry candidates will be exempt from the requirements to undertake the education or training relating to the first three points noted above. Please refer to Experienced Entry Requirements later in this document.

### **Mandatory Performance Framework Education**

All fair value credential candidates, including those who have met the Experienced Entry requirements, will be required to undertake education on the application of the Mandatory Performance Framework that is being developed by the Performance Requirements workstream outlined previously. This education will be delivered by each of the approved VPOs.

### **Assessment of Competence**

All fair value credential candidates, including those who have met the Experienced Entry requirements, must successfully pass a uniform assessment relating to the application of the Mandatory Performance Framework to the fair value Body of Knowledge. The assessment will be delivered with two sections in a multiple choice format. Part 1 will test the candidate's knowledge and understanding of the Mandatory

Performance Framework. Part 2 will require the individual to demonstrate their ability to apply the Mandatory Performance Framework requirements to the fair value Body of Knowledge through a case study.

### **Experienced Entry Requirements**

Fair value measurement practitioners with a defined level of fair value-related experience will qualify for Experienced Entry. Experienced Entry candidates will be exempt from the requirements to undertake the education relating to the valuation and fair value Body of Knowledge. They will, however, be required to undertake the education on the Mandatory Performance Framework and meet all other assessment and approved VPO membership requirements.

In order to meet the Experienced Entry requirements, candidates **MUST** have a minimum of ten years of valuation experience (approximately 20,000 hours) with at least 50% of this experience (approximately 10,000 hours) being directly related to fair value measurements. Experience must be attested to by a supervisor, except for individuals such as senior leadership with demonstrated experience related to valuations of businesses and intangible assets. The Experienced Entry exemption will be open for a maximum of two years from the credential launch date.

### **Timeframe**

Fair value credential candidates must meet all the experience, education, and assessment requirements before applying for the fair value credential.

### **Ongoing Requirements**

All fair value credential holders must meet the following requirements to maintain and continue to hold the fair value credential:

- 48 hours of fair value measurement-related Continuing Professional Education (CPE) over a rolling three-year period. The CPE can include but is not limited to webcasts, conferences, classroom training, and other CPE events. An eight hour fair value measurements update will be required annually;
- Compliance with the Mandatory Performance Framework;
- 1,500 hours of fair value measurements-related experience over a rolling three year period; and
- Submission to ongoing engagement level quality review.

The time periods above will be in line with the measurement of CPE, also known as Continuing Professional Development (CPD), for each approved VPO.

## **Quality Control**

The Quality Control (QC) work-stream has drafted a preliminary outline that will become the framework used by the VPOs to assess the work-product of credentialed individuals. The goal of the Quality Control Framework will be to provide confidence to the markets and regulators that credentialed professionals are performing high quality valuations.

## Key Elements Considered

The following elements were considered in developing the Quality Control Framework:

- Frequency of Review
- Depth of Review
- Type of Review
- Communication
- Disciplinary Approach
- Independence of Review
- Credibility of Review
- Staffing of Quality Control
- Outcomes

## What should be reviewed and how often?

Quality Control will encompass a combination of reviews of CPE requirements, complaints received (including anonymous), as well as review of work performed. Reviews need to be structured to gather and evaluate evidence needed to demonstrate core areas of the Mandatory Performance Framework are being followed. The right to investigate a credential holder would also be encompassed in the QC process in the case of complaints or a damaging story in the public domain.

No review of a fair value credential holder will take place within the first nine-months after receipt of the credential, unless a complaint against a credential holder requires an investigative review. Thereafter, following the initial quality control review, an annual risk-based approach will be implemented.

In the risk-based approach, the fair value credential holder completes an annual return for their VPO which receives a risk score. If the risk score (which is confidential) is high, it means there is potentially a greater risk of fair value measurements not being performed correctly which will result in the VPO undertaking a Quality Control Review for the individual. To confirm the effectiveness of the risk-based approach, there will also be a randomly selected control sample from the rest of the credential population in order to verify that the risk-based approach is a balanced one. The sample levels will be further reviewed once established.

Minimum key steps of the compliance and review process involve a three-tiered approach:

1. First level of review will be completed by a reviewer either through a site visit or, if requested, through a remote review. The reviewer will be an independent third party. If major findings are identified, the report will be sent to a Review and Disciplinary Panel for a second level of review and potential sanctions.
2. The second level of review will be carried out by an independent Review and Disciplinary Panel (set up by each VPO), and the participating firm will be able to make representations. This second level of review will consider findings, hear from the party concerned, confirm whether the findings are valid, and if so, determine what sanctions are necessary.

3. The third level of review will involve some form of independent appeal. Independent appeal is necessary to provide sufficient due process to the practitioner under inspection. All individuals will have the right to appeal determinations made by the Review and Disciplinary Panel to a different Appeals Panel, made up of different participants.

### **Independence and Credibility of Quality Control**

In order to have credibility and avoid conflicts of interest (or perceived conflicts of interest), it is important that QC reviewers and any Review and Disciplinary Panels set up by the VPOs have sufficient independence from the VPO to demonstrate fairness and impartiality.

There should be a pool of panel participants in sufficient numbers, geographical spread, and expertise to cover QC needs. The Appeals Panel can be formed from the same pool, but an individual may only participate once in any process (i.e., someone sitting on a Review and Disciplinary Panel cannot then hear an appeal regarding the same individual they made a decision against).

### **Outputs from a Review or Investigation**

An exception report will be produced from each review or investigation which will highlight any areas of deficiency and make recommendations to the individual on the appropriate level of remediation. Reports should always have a file of evidence to support the conclusions.

Pursuant to the previous section, if a report identifies one or more significant deficiencies, a Review and Disciplinary Panel will review the file and ask for representations from the professional under review for any information regarding aggravating or mitigating circumstances. When this information has been incorporated into the review record, the Review and Disciplinary Panel will decide what, if any, sanctions should be put in place. All individuals will have the right of appeal to a different panel.

Where the credential is removed, the Review and Disciplinary Panel needs to consider whether re-admission should be permitted in the future and, if so, what criteria needs to be fulfilled. Lifetime bans from the fair value measurement credential would be applicable in particular for significant ethical breaches.

In some instances, a VPO may not allow an individual to resign from the organization once a disciplinary process has commenced. Where a professional body allows an individual to leave before a disciplinary process is complete, then the process needs to be re-instigated should the same individual seek future re-admission.

Where an individual leaves or is removed from the credential program, the reasons behind this will be made available to other professional bodies.

The primary goal of the QC structure is initially to work with practitioners to help them incorporate the appropriate level of skill (through education and compliance with the new Mandatory Performance Framework) which, in turn, should raise quality and improve fair value reporting.

## Conclusion

In order for the valuation profession to grow and improve, it will need to implement the key elements of a professional infrastructure that will govern individuals conducting fair value measurements for financial reporting purposes for SEC-registered U.S. public companies. This will require adherence to consistent professional and technical standards as well guiding principles that help define 'how much' work is necessary to provide supportable and auditable fair value measurements. The incorporation of a credentialing program that will require additional training and ongoing quality oversight, as well as an enhanced level of performance, will ensure consistency and transparency in the fair value measurement process. The desired results of the fair value quality initiative are the positive impact it should have on the audit process and increased confidence in the work performed by these credentialed specialists who conduct fair value measurements for U.S. public companies.

The purpose of this progress report is to provide background and other pertinent information about the issues facing the valuation profession and how they are being addressed. The American Institute of Certified Public Accountants, American Society of Appraisers, and Royal Institution of Chartered Surveyors welcome feedback and dialogue; however, this document is not an exposure draft. An exposure draft of the Mandatory Performance Framework will be released for public comment in mid-May.