The Role of the FASB and the IASB in Establishing Fair Value Measurements

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Familiarity with the accounting standards regarding fair value measurements will help taxpayers, valuation analysts, and tax attorneys understand some of the differences between the fair value standard of value and other standards of value (e.g., fair market value). This discussion provides a historical overview (1) of the Financial Accounting Standards Board and the International Accounting Standards Board and (2) of the progress that they have made towards establishing common guidance on fair value measurements.

Introduction

In the United States, the Financial Accounting Standards Board (FASB) has the task of establishing financial accounting standards that govern the preparation of financial reporting by nongovernmental entities. The International Accounting Standards Board (IASB), another standard-setting organization, is responsible for providing the world's capital markets with a common language for financial reporting.

In May 2011, the FASB and the IASB promulgated new accounting standards that focus on establishing a single source of generally accepted accounting principles (GAAP) related to fair value measurements.

Corporate taxpayers, valuation analysts, and tax attorneys should be generally familiar with the accounting standards regarding fair value measurement. These professionals should be familiar with the differences between fair value (as used in valuations prepared for financial accounting purposes) and fair market value (as used in valuations prepared for income tax and other tax purposes).

When a fair value valuation is performed for financial accounting purposes, there may be a temptation for parties to use this fair value for other purposes. Corporate taxpayers and tax attorneys should avoid this temptation. This is because of the differences between (1) fair value (as applied in financial accounting) and (2) fair market value (as applied for most property, income, gift, and estate tax purposes).

This discussion provides a historical overview of (1) the two accounting standards-setting boards and (2) their work towards achieving convergence and professional guidance on fair value measurements.

Furthermore, this discussion provides practical guidance for taxpayers, tax lawyers, and valuation analysts regarding the particular standards that define and discuss various components of fair value measurements.

FASB Background

The first major attempt at creating standardized GAAP began in 1930, primarily as a result of the stock market crash in 1929. It was believed that the lack of uniform and stringent financial reporting requirements had contributed to the rampant stock market speculation that subsequently led to the market crash.

After the stock market crash, the American Institute of Accountants (later renamed the American Institute of Certified Public Accountants, or AICPA) created a special committee (the "Committee") to work with the New York Stock Exchange (the

"Exchange") to establish standards for financial accounting and reporting.

The Committee recommended rules to the Exchange known as Accounting Research Bulletins of the Committee on Accounting Procedure. Ultimately, the Committee published 51 such bulletins.

However, the Committee's limited resources and lack of serious research efforts in support of its pronouncements led to its replacement by the Accounting Principles Board (APB) in 1951.

The APB was formed to develop accounting principles and practices using the research conducted by the Accounting Research Division of the AICPA. Unfortunately, the APB did not operate differently or more effectively than the Committee on Accounting Procedure.

In 1972, the AICPA, based on the recommendations of the "Wheat Study Group"[1] recommended the formation of the Financial Accounting Standards Board (FASB). The FASB was formed—and still operates—as the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities.

The FASB develops financial accounting standards using a comprehensive and independent process that (1) encourages broad participation, (2) objectively considers all stakeholder views, and (3) is subject to oversight by the Financial Accounting Foundation's Board of Trustees.

The standards-setting process under the FASB is extensive and is open to public observation and participation. The following seven procedures provide a high-level overview of the standards-setting process established by the FASB Rules of Procedure.

This overview summarizes the FASB's operating procedures:

1. The FASB identifies a financial reporting issue based on requests or recommendations from stakeholders.
2. The FASB chairman decides whether to add a project to the technical agenda (a) after consulting with the FASB members and others as appropriate and (b) subject to oversight by the Financial Accounting Foundation's Board of Trustees.
3. At one or more public meetings, the FASB deliberates the various reporting issues identified and analyzed by its staff.
4. The FASB issues an Exposure Draft to solicit inputs from various stakeholders. (In some projects, the FASB may issue a Discussion Paper in order to obtain input in the early stages of a project.)

   The Exposure Draft presents the proposed standards, the proposed effective date and method of transition, background information, and an explanation of the basis for the FASB conclusions.
5. The FASB holds a public roundtable meeting on the Exposure Draft, if necessary.
6. The FASB staff analyzes comment letters, public roundtable discussion, and any other information obtained through the due process activities. The FASB re-deliberates the proposed provisions, considering the input received, at one or more public meetings.
7. The FASB issues an Accounting Standards Update, describing amendments to the Accounting Standards Codification (ASC).

Only AICPA committees that receive authorization from the AICPA Council can issue professional standards for CPAs. The Auditing Standards Board (ASB) is one such organization that can issue professional auditing standards.

The ASB issues auditing standards in the form of Statements on Auditing Standards, Statements on Standards for Attestation Engagements, and Statements on Quality Control Standards.

Although a non-AICPA organization, the FASB has standards-setting authority with the support of the Securities and Exchange Commission (SEC). "The Financial Reporting Release 1" of the SEC and Rule 203 of the AICPA "Code of Professional Conduct" recognize the authority of the FASB.

However, the SEC makes the final decision regarding financial accounting standards for public companies in the United States under the Securities Exchange Act of 1934.

The AICPA provides technical support and guidelines in conjunction with the work of the FASB. The FASB and the Governmental Accounting Standards Board (GASB) are authorized to establish generally accepted accounting principles (or GAAP).

Generally Accepted Accounting Principles

GAAP is a technical accounting term that encompasses the rules and procedures that define accepted accounting practice at a particular time. GAAP is developed when questions arise about the measurement of a particular economic activity,

for instance, when such measurement is to be made and recorded and the disclosure of this economic activity and its presentation in the form of financial statements.[2]

There is a long-standing debate regarding whether (1) all assets and liabilities should be reported on financial statements at fair value or (2) financial statements should be prepared under the current U.S. GAAP "mixed attribute model," using both historical cost and fair value.

On the one hand, investors argue that reporting financial instruments at historical cost deprives them of information related to the economic losses and gains associated with changes in the financial instruments' fair values.

On the other hand, some observers argue that reporting assets and liabilities at fair value creates "procyclicality," whereby the reporting of fair values has the effect of directly influencing the economy and, potentially, causing great harm.

For more than a decade, the FASB has maintained its position of having all financial assets and liabilities reported at fair value.

However, the FASB has been slow and deliberate in attaining this goal for the following reasons:

- Many of the projects on the FASB agenda are intertwined and have implications that affect fair value measurements and disclosures.
- The FASB has been preoccupied with other priorities involving complex, controversial issues arising from the current volatile business environment.
- The FASB had encountered unforeseen technical complexities. For example, when the FASB completed the initial phase of drafting ASC 480, Distinguishing Liabilities from Equity, the implementation of this standard had to be postponed as it became apparent that some of its provisions would have produced certain unintended consequences.[3]

FASB Codification

On July 1, 2009, the FASB completed its project to codify GAAP, when the FASB Accounting Standards Codification (the "Codification") became the single official source of authoritative, nongovernmental U.S. GAAP. At that time, all existing GAAP literature was officially withdrawn.

The Codification does not change GAAP, but rather introduces a new structure to GAAP, organizing the many GAAP pronouncements into about 90 accounting topics and displaying all topics using a consistent structure.

The Codification content is arranged within the following categories:

1. Topics
2. Subtopics
3. Sections
4. Subsections

Researching GAAP using official sources requires familiarity with, and access to, the FASB Accounting Standards Codification.

Also effective July 1, 2009, all amendments to the Codification are communicated through an Accounting Standards Update (ASU). ASUs are published for all authoritative GAAP promulgated by the FASB. ASUs are also issued for amendments to the SEC content in the Codification, as well as for editorial changes.

An ASU is a document that (1) summarizes the key provisions of the project that led to the ASU, (2) details the specific amendments to the Codification, and (3) explains the basis for the FASB decisions.

The FASB does not consider ASUs as authoritative in their own right. Instead, ASUs serve only to update the Codification, provide background information about the guidance, and provide the basis for conclusions on the change(s) in the Codification.

The FASB and Fair Value Measurement

Codification Topic 820 (ASC 820), *Fair Value Measurements and Disclosures* (formerly FASB Statement No. 157 *Fair Value Measurements*) provides the following:

1. A unified definition of fair value
2. Related guidance on measurement and enhanced disclosure requirements to inform financial statement users about the fair value measurements included in the financial statements
3. The methods and assumptions used to estimate fair value
4. The degree of observability of the inputs used in management's estimation process.

ASC 820 maintains the exceptions that existed in GAAP that apply when, in management's judgment, it is not practical to estimate fair value.

ASC 820 is now the sole source for guidance on how entities should measure and disclose fair value in their financial statements.

ASC 820 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."

The fair value standard focuses on the sale of an asset or the transfer of a liability using an exit price, unadjusted for transaction costs.

One of the most significant elements of ASC 820 is the use of a three-level fair value hierarchy. The hierarchical approach to determining fair value in ASC 820 is summarized as follows:

- Level 1—Inputs are observable market inputs that reflect quoted prices for identical assets or liabilities in active markets. Observable inputs are inputs based on market data obtained from sources independent of the company.

  These inputs should not be limited to information that is only available to the company making the fair value determination or to a small group of users.

  Observable market inputs should be readily available to participants in that market. In applying the market approach, using the price of a stock trading on the New York Stock Exchange is considered a Level 1 input.
- Level 2—Inputs are observable market inputs other than quoted prices for identical assets or liabilities in active markets. In a valuation model, the use of the quoted price of a similar asset in an inactive market is considered a Level 2 input.
- Level 3—Inputs are unobservable market inputs (e.g., inputs derived through extrapolation or interpolation that cannot be corroborated by observable market data).

ASC 820 allows reporting entities to use three valuation approaches to estimate fair values:

1. The market approach (a company may use the prices of comparable assets or liabilities and other information from market transactions)
2. The income approach (a company may use discounted cash flows or earnings models)
3. The cost approach (a company may use the current replacement cost)

Examples of assets and liabilities that require fair value accounting include interests in variable interest entities, accounts receivable, goodwill, and accounts payable. Some assets and liabilities that do not use fair value include inventories, leases, and pension assets and liabilities.

ASC 820 intends to accomplish the following:

- Establish a single, consistent GAAP definition of fair value
- Provide uniform, consistent guidance on how to measure fair value including the establishment of a hierarchical fair value measurement framework that classifies measurement inputs based on their level of market observability
- Expand the information required to be provided to financial statement users abut fair value measurements

ASC 820 is not intended to mandate new fair value measurements. Rather, ASC 820 provides "clarification" regarding the application of these measurements in the existing literature.

The IASB and IFRS

International Financial Reporting Standards (IFRSs) are accounting standards promulgated by the IASB. The goal of the IASB is to provide the world's capital markets with a common language for financial reporting.

The IASB is the standard-setting body of the IFRS Foundation, an independent, not-for-profit private sector organization working to develop a single set of understandable, enforceable, and globally accepted international financial reporting standards.

In 2001, the IASB replaced the International Accounting Standards Committee (IASC), the organization previously responsible for international accounting standards. The IASB officially adopted the standards issued by the IASC, called the International Accounting Standards (IAS).

Unlike GAAP, IFRSs are based on principles, rather than on strict rules. Principles-based accounting permits a broader interpretation of accounting standards.

Since IFRSs require some assets and liabilities to be measured at fair value in certain circumstances, the concept of fair value measurement is integral to the IASB's conceptual framework.

Fair Value Measurement Convergence

The FASB and the IASB agreed to the convergence of accounting standards in 2002 as part of the Norwalk Agreement.

In 2006, the two boards jointly issued a Memorandum of Understanding in which "each acknowledged their commitment to development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting."[4]

The Memorandum of Understanding outlines the principles contained in the Norwalk Agreement. These principles are as follows:

- Convergence of accounting standards can best be achieved through the development of high-quality, common standards over time.
- A new common standard should be developed that improves the financial information reported to investors.
- To serve the needs of investors, the Boards should seek convergence by replacing standards in need of improvement with jointly developed new standards.

In November 2006, the IASB issued a discussion paper on fair value measurements in anticipation of eventually issuing an Exposure Draft similar to ASC 820. The intent of the IASB Fair Value Measurement Project is not to expand the use of fair value, but instead to clarify how to measure fair value consistently across all existing pronouncements.

On May 12, 2011, FASB announced that it and the IASB had amended their rules so that the term "fair value" would have the same meaning under U.S. GAAP and IFRS.

The IASB issued IFRS 13, *Fair Value Measurement*, and the FASB concurrently issued ASU 2011-4, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.

IFRS 13 applies the same definition of fair value defined in ASC 820. IFRS 13 emphasizes that fair value is an exit price, as opposed to fair market value which is an entry price.

ASU 2011-4 changes several aspects of the fair value measurement guidance in ASC 820, including the following:

- Application of the concepts of highest and best use (HABU) and valuation premise (in-use or in-exchange). These concepts apply only to the fair value measurement of non-financial assets such as inventory, and not to the fair value measurement of liabilities or financial assets.

  The amendment clarifies that a company must measure a nonfinancial asset's fair value based on its HABU from the perspective of a market participant. The amendment also prohibits the use of the terms "in-use" and "in-exchange" to describe valuation premises associated with the concept of HABU for the reason that the definitions of these terms are unclear.
- Allowance of an option to measure groups of offsetting assets and liabilities on a net basis.

  The amendment allows a company to measure the fair value of a group of financial assets and financial liabilities that are within the scope of ASC 815, *Derivatives and Hedging*, or ASC 825, *Financial Instruments*, on the basis of either the price the company would receive to sell a net long position or the price it would pay to transfer a net short position, for a particular risk exposure.
- Incorporation of certain premiums and discounts in fair value measurements in the absence of a Level 1 input.

  The amendment prohibits the application of block discounts for all fair value measurements, regardless of hierarchy level.

- Measurement of the fair value of certain instruments classified in shareholders' equity.

  In the amendment, a company would measure the fair value of an instrument classified in shareholders' equity from the perspective of a market participant holding the identical item as an asset at the measurement, in the absence of a quoted market price.

In addition, the amended guidance includes several new fair value disclosure requirements, including the following:

1. Information about valuation techniques and unobservable inputs used in Level 2 and Level 3 fair value measures
2. Reason(s) for using fair value measurement
3. Description of transfers between Level 1 and Level 2 in the fair value hierarchy
4. A narrative description of Level 3 measurements' sensitivity to changes in unobservable inputs

Some of the new disclosures are not required for nonpublic entities.

Neither IFRS 13 nor ASU 2011-4 dictates when and which assets and/or liabilities are required to be reported at fair value. In addition, the FASB and the IASB both asserted that their most recent guidance on fair value accounting did not expand the use of fair value accounting to new assets and liabilities.

Rather, the new guidance was designed to more clearly define "fair value" to ensure a comprehensive disclosure process and to standardize language so that GAAP and IFRS are consistent. Further, both IFRS 13 and ASU 2011-4 provide a framework on how fair value is to be measured and which information is required to be disclosed in fair value measurements.

ASU 2011-4 becomes effective in the first quarter of 2012 for public companies with fiscal years ending in the calendar year. Early adoption for public companies is not permitted. Privately held companies are required to apply the amendments in fiscal years beginning after December 15, 2011.

Despite the FASB and the IASB new common guidance on fair value accounting, there are still a few remaining difference between U.S. GAAP and IFRS, including the following:

- Measurement of investments in investment companies; IFRS does not provide guidance on investment company accounting
- Measurement of a deposit liability
- Disclosure of certain Level 3 measurements on a net basis

- Disclosure of a quantitative sensitivity analysis for Level 3 measurements; IFRS requires a quantitative sensitivity analysis for Level 3 financial instruments
- Applicability of disclosure requirements to nonpublic entities

The SEC has indicated that IFRS might provide the basis for universal accounting standards. The SEC has stated that it will decide before the end of 2011 whether to incorporate IFRS into the U.S. financial reporting system.

The SEC has explored several possible approaches to incorporating IFRS in the reporting standards for issuers of U.S. securities, including the following possibilities:[5]

1. Require full adoption of IFRS as issued by the IASB on a specified date
2. Require full adoption of IFRS following a transition period of several years
3. Allow, but not require, issuers of U.S. securities to prepare financial statements in accordance with IFRS.

While the SEC has yet to endorse the IFRS, the converged guidance on fair value measurements by the FASB and the IASB provides several benefits to the valuation profession.

The new guidance from the FASB and the IASB provides the valuation analyst with (1) information about a company's valuation processes and (2) any changes in management's views on valuing various assets or liabilities.

For example, if a company reports the value of residential mortgaged-back securities on its balance sheet, under the new fair value guidance, the company will disclose certain information relating to the securities. That information includes the prepayment rate and probability of default.

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This caution is due to the fact that there is the potential to overstate the value of the taxpayer's assets. This overstatement may occur if the merged and acquired company method is used without adequate consideration of what the "transaction price" truly represents. If the market-derived valuation pricing multiples represent investment value (i.e., the multiples include some synergistic premium), a value conclusion based on these pricing multiples may be greater than fair market value.

This issue is particularly important to centrally assessed taxpayers with regard to property tax assessment appeals and litigation. This issue is important. This is because M&A pricing multiples are often applied to the financial fundamentals of the subject property in order to estimate the unit value of the subject taxable assets.

Many M&A transactions (both of companies and operating properties) are strategic acquisitions. As a result, the indicated M&A transaction prices—and the resulting pricing multiples—may provide an indication of investment value rather than of fair market value.

Many M&A transactions occur at substantial acquisition synergy price premiums—when compared to fair market value price premiums. These acquisition synergy price premiums are supported by the post-merger economic synergies that are expected from the transaction.

Of course, each acquisition of a company or an operating property is a unique transaction. Accordingly, market-derived valuation pricing multiples from M&A transactions should not be used to value a subject property without an adequate understanding of

1. the terms of each transaction and
2. the particular facts and circumstances of each industry.

Notes:

1. "Mergers, Acquisitions, and Leveraged Buyouts." 2001 CFM Level II Study Guide (Downers Grove, IL: Stalla Seminars, Inc., 2001): EQ-274.
2. *Mergerstat Review* 2011 (Newark, NJ: FactSet Mergerstat, LLC, 2011): 43.
3. Ibid.: 4.

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If the residential mortgaged-back securities are valued using the discounted cash flow method, the reporting entity will disclose the cost of capital, long-term growth rate, and operating margins it had used in the analysis.

Conclusion

For many decades, the FASB and the IASB established separate accounting standards for financial reporting. In 2011, the FASB and the IASB initiated their goal of issuing common guidance on fair value measurements.

Understanding the particular accounting standards that define fair value will provide professional guidance for corporate taxpayers, tax lawyers, and valuation analysts when applying the fair value standard of value.

Notes:

1. Stephen A. Zeff, "The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards," *The CPA Journal* (2005).
2. Steven M. Bragg, *GAAP 2011: Interpretation and Application of Generally Accepted Accounting Principles*, (New York: John Wiley & Sons, 2010).
3. ASC 480 contains a provision requiring reporting entities that issue mandatorily redeemable common stock to classify these instruments as liabilities. Implementation of this provision adversely affected many privately held businesses whose common stock was subject to "buy-sell" agreements that obligated the reporting entity to redeem the owners' stock upon the event of their death. Application of ASC 480 would have required that 100 percent of these companies' equity be classified as liabilities, causing many of them to be in violation of restrictive debt covenants, or leaving them unable to obtain credit enhancements, such as guarantees, letters of credit, or surety bonds.
4. The Memorandum of Understanding was updated on September 11, 2008. On November 5, 2009, the FASB and IASB issued a joint statement, "FASB and IASB Reaffirm Commitment to Memorandum of Understanding," www.ifrs.org (accessed October 13, 2011).
5. Elizabeth A. Evans and Hong Qiao, "The Evolution of Fair Value Accounting," *Valuation Strategies* (July/August 2011): 15.

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