CHAPTER ONE

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The History and Evolution of Fair Value Accounting

FAIR VALUE ACCOUNTING has changed the way financial information is presented. Where once financial statements were based primarily on historical costs, under certain circumstances, fair value is often the basis of measurement for reporting for both financial and nonfinancial assets and liabilities. Measuring fair value often requires experience and judgment, and it has the potential to introduce bias into financial statements. A trend toward increasing the amount of financial statement information presented or disclosed at fair value persists under U.S. generally accepted accounting standards (GAAP) and International Financial Reporting Standards (IFRS). The trend away from historical costs, which has been the bedrock of traditional accounting, toward fair value accounting has been challenging for preparers, auditors, standards setters, and regulators.

Fair value accounting is a financial reporting approach that requires or permits entities to measure and report assets at the price assets would sell and liabilities at the estimated price that a holder would have to pay in order to discharge the liability. The term *fair value accounting* not only refers to the initial measurement but can also refer to subsequent changes in fair value from period to period and the treatment of unrealized gains and losses in the financial statements. Therefore, fair value accounting affects the reported amounts for assets and liabilities in the balance sheet and affects the reported amounts for unrealized gains or losses shown in the income statement or in the other comprehensive income section of shareholders' equity. In financial reporting, fair value accounting is often applied to financial instruments such as investments in stocks, bonds, an entity's own debt obligations, and derivative instruments like options, swaps, and futures. When unadjusted or adjusted market prices are the basis for fair value estimates of financial assets and liabilities, the process is often called mark-to-market accounting.

Fair value accounting is applicable to nonfinancial assets and liabilities as well, but in more limited circumstances. For instance, when an entity is acquired in a business combination, all balance sheet assets and liabilities are recorded at fair value. Subsequent to the acquisition date, fair value is the basis for testing acquired goodwill for impairment. Likewise, fair value is the benchmark when testing property, plant, and equipment and amortizable intangible assets for impairment.

Fair value measurement is the process for determining the fair value of financial and nonfinancial assets and liabilities when fair value accounting is required or permitted. Therefore, fair value measurement is broader than mark-to-market accounting. It encompasses estimating fair value based on market prices as well as estimating fair value using valuation models. The Financial Accounting Standards Boards (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurement*, provides authoritative guidance for measuring the fair value of assets, liabilities, and equity interests when fair value accounting is required or permitted in other accounting standards. The International Accounting Standards Board (IASB) has an identical standard, IFRS 13, *Fair Value Measurements*.

Advocates of fair value accounting believe that fair value best represents the financial position of the entity and provides more relevant information to the users of the financial information. Detractors believe that fair values are unreliable because they are difficult to estimate. Critics also believe that reporting temporary losses is misleading when they are likely to reverse, and those critics believe that reported losses adversely affect market prices and market risk.[1] In spite of the criticism, fair value accounting has become more prominent in financial statement presentation and will continue to be a fundamental basis for accounting in the future.

In December 2018, the IASB published a postimplementation review of IFRS 13, *Fair Value Measurements*, which is conducted periodically by both the IASB and the FASB to determine whether accounting standards are working as intended. In a summary of their findings, the IASB concluded the following:

- "The information required by IFRS 13 is useful to users of financial statements.
- Some areas of IFRS 13 present implementation challenges, largely in areas requiring judgment. However, evidence suggests that practice is developing to resolve these challenges.
- No unexpected costs have arisen from application of IFRS 13.[2]

The IASB further concluded that the findings of the postimplementation review on fair value measurements should be incorporated into the project about better communication in financial reporting. The Board also concluded that it needed to better liaise with the valuation profession, including monitoring new developments with valuation specialists.

WHY THE TREND TOWARD FAIR VALUE ACCOUNTING?

In recent years, there has been an increasing trend toward the use of fair value accounting in financial reporting. Even when fair value accounting is not required and financial statements are prepared using some other measurement basis, there is a likelihood that related disclosures will require the presentation of fair value information. Several factors are influencing the trend toward fair value accounting: the growing economic importance of intellectual property, globalization, and investors' desire for financial statements that are more relevant and transparent.

The Changing Economy

The economy in the United States has undergone tremendous changes over the past quarter-century due to a rapid rate of technological innovation. The explosion in the use of personal computers and digital media has created whole industries that did not previously exist. One product of technological innovation that contributed to economic change is the commercialization of the Internet, which resulted in what some call the *information revolution*. The result of this technological and economic change is that a significant portion of the U.S. economy shifted from bricks-and-mortar businesses to information-based businesses.

This economic change has led to a growing recognition that the value driver of many business entities lies within their intellectual property, not just in their inventory, plant, and equipment. Financial statement users also recognize that intellectual property has not been effectively measured under traditional cost-based accounting practices. The reason is that existing accounting principles require internally created intellectual property to be expensed as research and development.

Ocean Tomo, an intellectual capital merchant banking firm, produces an Annual Study of Intangible Asset Market Value that breaks down the Standard & Poor (S&P) 500's equity market value into an implied intangible asset value and a tangible asset value. In 2015, tangible and financial assets generated approximately 13 percent of the S&P 500's market value. While tangible and financial assets are reflected on company balance sheets, the remaining 87 percent of value attributable to intangible assets is often not recognized at all.[3] The market-to-book ratio for the S&P 500 as of December 31, 2018, was approximately 2.94[4] This ratio indicates that only about a third of the value of the market capitalization on average is recognized by current accounting standards. This value gap has increased in recent years, highlighting the increasing importance of intangible assets (including intellectual property) in the overall market capitalization of publicly traded companies.

Globalization

The International Monetary Fund defines *economic globalization* as "a historical process; the result of human innovation and technological process. It refers to the increasing integration of economies around the world, particularly through the movement of goods, services and capital across borders." Globalization has accelerated since the 1980s as a result of technological advances that made international financial and trading transactions easier and quicker.[5] This increasing globalization of business has created a need for consistent accounting standards across national boundaries.

The FASB and the IASB recognize that users of financial statements would benefit from having one set of international accounting standards that could be used for domestic and international, cross-border financial reporting. As a result, both organizations have been working for several years to jointly create accounting standards and to converge U.S. GAAP with international accounting standards (IAS). According to the FASB, *convergence* refers to both the goal of establishing a single set of high-quality international accounting standards and the path taken to reach that goal, which includes the collaborative efforts "to improve existing U.S. GAAP and International Financial Standards and eliminate the differences between them."[6] Historically, IAS have been more principal based, requiring more fair value measurement than U.S. GAAP, which are considered more rules based, requiring more cost-based measurement. As the accounting standards converge, U.S. GAAP is requiring more fair value accounting measures.

The history and evolution of fair value measurement encompasses the recent convergence of U.S. GAAP and IAS pertaining to fair value measurement. The five-year joint FASB and IASB project was undertaken to improve and align fair value measurement and disclosure requirements and to respond to the global financial crisis.[7] As originally promulgated, the FASB's Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements and Disclosures*, influenced the development of International Financial Reporting Standard (IFRS) 13, *Fair Value Measurement*. Convergence has shaped U.S. accounting standards through updates to FASB ASC 820. The FASB's Accounting Standards Update (ASU) 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, which was issued in May 2011, eliminated most of the significant remaining differences between U.S. and international accounting standards for measuring fair value. The move and subsequent halting of the Convergence Project as it pertains to fair value measurements is discussed in greater detail in this chapter.

Relevance and Transparency

An important characteristic of efficient capital markets is that prices are the result of the market's correct assessment of all available information. The FASB recognizes that better financial reporting leads to stronger capital markets by helping investors make informed decisions. One of the FASB's stated goals is "to set accounting standards that produce financial information useful in helping investors decide whether to provide resources to a company, and whether the management of that company has made good use of the resources it already has."[8]

In an effort to make financial reporting more relevant to investors, the FASB has encouraged investors to participate in the accounting standards process by providing comments on discussion papers and exposure drafts that are issued at various stages of the FASB's projects. The FASB has asked interested investors to provide expert advice to the FASB's designated "investor liaison" staff members in conjunction with FASB projects. The goal is to improve the relevance of accounting standards for investors in a cost-effective manner.

Two other investor advisory groups provide input to the FASB from the investor perspective, the Investors Technical Advisory Committee (ITAC) and the Investor Task Force (ITF). The ITAC is focused on providing technical accounting advice and increasing investor participation in standard setting.[9] The ITF is made up of institutional asset managers who analyze various sectors of the economy. The ITF provides advice to the FASB about the impact of various accounting standards proposals on specific industry sectors.[10]

The Securities and Exchange Commission (SEC) is equally committed to advancing high quality accounting standards that are responsive to investors' needs. In testimony before a Congressional subcommittee, SEC Director John M. White said,

> An open process that allows standards setters to seek and thoughtfully consider the views of market participants is critical to establishing, maintaining, and continually improving financial accounting and reporting standards. We are committed to high quality accounting standards and a transparent financial reporting system that meets the needs of investors and other market participants.[11]

Transparency in financial reporting is the unbiased, clear, complete presentation of a company's financial position. Information in the management discussion and analysis (MD&A) section of the financial statements about existing risk and uncertainty and about the likely future impact of risk and uncertainty on the company's prospects further promotes transparency. When financial reporting is transparent, investors are better able to make decisions and avoid surprises. On a macroeconomic scale, transparency leads to more efficient allocation of capital and stronger capital markets. In the aftermath of the economic crisis, there was a debate about whether fair value accounting promoted financial statement transparency or whether it caused the meltdown. In a 2008 report to Congress, the SEC found that "investors generally believe that fair value accounting increases financial reporting transparency and facilitates better investment decision-making."[12] The CFA Center for Financial Market Integrity concurs with the SEC's view. It supports fair value as "the most transparent measurement for investors to analyze financial statements," and it said, "fair value is being used as a scapegoat by corporations who have made poor decisions or were not in compliance with accounting standards."[13]

The financial crisis has presented a challenge and an opportunity for the SEC and the FASB to reaffirm their missions and assess their success in achieving their goals. The SEC's mission is to "protect investors, provide for efficient markets, and to facilitate capital formation."[14] The FASB's mission is "to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports."[15] The SEC and the FASB have renewed their efforts to ensure greater transparency in financial reporting and its relevance to investors since the financial crisis began and are likely to continue to do so for the foreseeable future.

HISTORY AND EVOLUTION OF FAIR VALUE

The FASB's Accounting Standards Codification (ASC) is the single, authoritative source for U.S. GAAP today. ASC superseded all previously issued U.S. GAAP accounting standards and reorganized them by topic. ASC became effective for interim and annual period beginning after September 15, 2009.[16] ASC 820, *Fair Value Measurement* (ASC 820), superseded the original FASB accounting standard SFAS 157 that was issued in 2006. In addition, any FASB Staff Positions that amended SFAS 157 have also been superseded by ASC 820. FASB Accounting

Standards Updates are included in the Codification once they reach their effective date. Those that have not reached their effective date are presented in separate "pending content" sections, adjacent to the subtopic they will replace. ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, is effective for all entities with reporting periods beginning after December 15, 2011. Since this discussion in this section pertains to the history of fair value measurements, the references are as the standards were originally presented under GAAP, much of which has now been codified under the ASC.

Fair value accounting is not a new requirement in financial reporting. Fair value has been a standard of measurement in financial reporting for decades. The FASB has issued dozens of statements that use fair value as the measurement of value. The concept of value contained in these statements is from a market perspective, not from the perspective of the reporting entity. Therefore, measuring fair value requires financial statement preparers to use judgment and to make assumptions consistent with those made by other market participants. The FASB has also issued a few statements with fair value–like measurement standards such as FASB ASC 718, *Compensation—Stock Compensation*. The main difference between these two measurement standards is that the fair value–like measurement standard does not incorporate an exit price assumption and fair value does. The assumptions underlying the fair value measurement framework of ASC 820 are covered in Chapter 2.

In September 2006, the FASB issued SFAS 157 (now codified as ASC 820) to clarify the concepts related to the measurement of fair value and to provide further implementation guidance.[17] According to the FASB, the reason for issuing SFAS 157 was to define fair value, establish a framework for measuring fair value, and expand disclosure about fair value measurements.[18] SFAS 157 did not introduce any new accounting requirements. Instead, it applied to all existing accounting statements that require assets or liabilities to be presented or disclosed in financial statements at fair value. As originally promulgated, the FASB intended SFAS 157 to provide one uniform statement under which the concept of fair value would be more fully explained.

When it was originally issued, SFAS 157 became a source of controversy in the United States. The banking industry was particularly vocal in its objections to mark-to-market accounting. Many criticized its application to liabilities, and preparers felt they needed more guidance to apply the Statement to nonfinancial assets and liabilities. In response to pressures from financial statement preparers and other constituents, the FASB announced that it would delay implementation for nonfinancial assets and liabilities for one year. The announcement came a few days before the Statement's original scheduled implementation date. The reason cited by the FASB for the partial implementation was "to allow the Board and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157."[19]

Even the partial implementation did not allay all the controversy. Some critics of fair value accounting claimed that the credit crisis that began in 2008 was exacerbated by financial institutions' implementation of SFAS 157. The Statement became fully effective for fiscal years beginning after November 15, 2008, for all items, including financial and nonfinancial assets and liabilities required under existing statements to be measured at fair value.

In order to better understand fair value measurement, this section covers the history and evolution of fair value measurement in financial reporting. It begins with a historical look back at the development of fair value concepts. Then it covers some of the more important milestones related to the development of fair value for financial instruments and fair value measurement for nonfinancial assets and liabilities. The economic crisis shaped fair value measurement and led to the refinement of several accounting standards and concepts as regulators and standards setters responded to the crisis. Convergence of U.S. GAAP and IAS has also shaped fair value measurement concepts. Finally, this section ends by discussing some trends that are likely to influence the future of fair value measurement.

Development of Fair Value Concepts

The concept of fair value has been evolving for over a century. In an 1898 U.S. Supreme Court case about railroad rate regulation, *Smyth v. Ames*, the Court discussed some of the concepts underlying *fair value* by saying:

> In order to ascertain that value, the original cost of constructions, the amount expended in permanent improvements, the amount and market value of its stocks and bonds, the present as compared to the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property.[20]

This reference to fair value alludes to several fair value measurement concepts that are currently in use, such as a cost approach, a market approach, economic value, and the application of judgment to weigh the various indications of value.

The FASB initially considered adopting the same definition of *fair market value* used for tax reporting requirements, and using it to describe fair value in financial reporting. However, the FASB ultimately decided on a unique definition for *fair value*; therefore, the terms *fair value* and *fair market value* are not interchangeable. The fair market value definition found in the *International Glossary of Business Valuation Terms* is the same as the tax definition of fair market value in Revenue Ruling 59-60, which states that it is

> the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[21]

Fair market value is the standard of value in all federal and state tax matters. It is often used to value ownership interests in entities, which is consistent with its transaction-based definition. The term *fair market value* has a significant body of interpretive case law, which was the primary reason the FASB decided to adopt a different standard of value with a specific definition for financial reporting.[22]

Fair value is the standard for financial reporting purposes. *Fair value* is defined in the *FASB Master Glossary* 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."[23]

Although *fair market value* has a rich history with respect to legal and tax matters, the application of fair value to financial reporting is a relatively new development. This section looks at the development of fair value concepts in financial accounting standards from a historical perspective.

One of the first accounting statements requiring the use of fair value in financial reporting was Accounting Principles Board (APB) 18, *The Equity Method of Accounting for Investments in Common Stock,* which was issued in 1971. APB 18 introduced the equity method of accounting for investments in unconsolidated subsidiaries. Under APB 18, a loss would be recognized when the investment's fair value declined below its carrying value and the loss was considered to be other than temporary.[24]

APB 29, *Accounting for Nonmonetary Transactions,* introduced in 1973, outlined ways to measure the fair value of nonmonetary transactions. It indicates that the fair value of a nonmonetary transaction should be determined by referring to cash transactions for the same or similar assets, quoted market prices, independent appraisals, and the estimated fair value of the asset or service received. Any determination of fair value using these methods would also have to consider whether the estimated value would be realized.[25]

In 1977, SFAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* established some important fair value concepts. SFAS 15 specifies that fair value is the amount determined through a current sale between a willing buyer and a willing seller, other than in a forced or liquidation sale. It also states,

> Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[26]

SFAS 15 established several important criteria for using a market approach and established the use of a discounted cash flow method for measuring fair value. These important concepts persist in financial reporting today.

Fair Value of Financial Instruments

The FASB has issued several accounting standards that apply to financial instruments including derivatives. One of the first was SFAS 2, *Accounting for Certain Marketable Securities*. Issued in 1975, SFAS 2 required that marketable securities be carried at the lower of cost or market value. It also established the practice of recording changes in the market value of an entity's noncurrent asset portfolio in a separate component of equity. Therefore, it permitted unrealized losses to bypass the income statement.

In 1991, SFAS 107, *Disclosures About Fair Value in Financial Instruments,* required the fair value disclosure of an entity's financial instruments. The requirement included all financial assets and liabilities, whether recorded or unrecorded in the financial statements.[27]

SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, was introduced in 1993. It established three categories of investment securities: held-to-maturity debt securities, trading securities, and available-for-sale securities. SFAS 115 also requires fair value as the standard of measurement for debt and equity securities classified as either trading or available-for-sale. Unrealized changes in the fair value of trading securities are recognized in earnings, whereas the unrealized changes in the fair value of available-for-sale securities are excluded from earnings and reported in a separate component of shareholders equity.[28]

In 1994, the FASB issued SFAS 119, *Disclosure About Derivative Financial Instruments and Fair Value of Financial Instruments*. It required entities that hold or issue derivative financial instruments for trading purposes to disclose the average fair value of those instruments. SFAS 119 also required that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments.[29]

In 2000 the FASB introduced FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, which required fair value as the measurement for derivative securities. The accounting treatment for changes in the fair value of derivative instruments depends on their classification as a fair value hedge, a cash flow hedge, a foreign currency hedge, or a derivative instrument not designated as a hedging instrument.[30]

With the issuance of SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, in 2007, the FASB expanded fair value measurements for financial instruments, which was consistent with the Board's long-term accounting measurement objectives for financial instruments. The FASB noted in the implementation guidance for SFAS 159 that the objective of the Statement is to improve financial reporting, "by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions."[31]

SFAS 159 permits entities to choose whether to measure financial assets and liabilities at fair value or whether to retain their current basis of measurement; therefore the fair value option is an election. It can be applied on an instrument-by-instrument basis, and there is no requirement to apply it to all financial assets or liabilities. Once an election is made to measure an instrument at its fair value under SFAS 159, the election is irrevocable (unless a new election date occurs). The financial instruments covered by the Statement are fairly broad. The majority of entities electing the fair value option under SFAS 159 are in the financial services industry, primarily commercial and investment banks.

A business entity electing the fair value option under SFAS 159 is required to report unrealized gains and losses resulting from changes in fair value in earnings at each subsequent reporting date. SFAS 159 was superseded by FASB ASC 825, *Financial Instruments*.

Fair Value Measurement for Nonfinancial Assets and Liabilities

During the technology boom in the late 1990s brought on by the initial commercialization of the Internet, the FASB began a project to update APB 16, *Business Combinations*. The FASB observed that during the 1990s, much of the economic value in mergers and acquisitions was driven by technology and other intangible assets owned by the acquired company. Yet these valuable assets were not being fairly presented in the financial statements because under APB 16, much of the value of the acquired entity was reported on the balance sheet as goodwill. And under accounting rules at that time, goodwill could be amortized for up to 40 years.

The FASB concluded that purchase price allocation to acquired assets and liabilities under APB 16 did not fairly represent the economic substance of business combinations, and that financial statements were not being fairly presented. The Board also concluded that companies had too much leeway in reporting the value of acquired intangible assets. As a result, the FASB made sweeping changes to the accounting standards for business combinations.

On June 29, 2001, the FASB issued SFAS 141, *Business Combinations*, which was superseded by SFAS 141 (Revised), *Business Combinations* (SFAS 141(R)), about six years later as a result of a joint FASB /IASB project. One of the first steps in the FASB and IASB project to converge U.S. GAAP with international accounting standards was to harmonize the accounting standards for business combinations; therefore, the FASB revised SFAS 141. The Boards issued common Exposure Drafts, which became SFAS 141(R) and IFRS 3, *Business Combinations*. The accounting standard for business combinations is now codified in FASB ASC 805, *Business Combinations*, and will be covered in greater detail in Chapter 3.

When it was originally issued in December 2007, SFAS 141(R) introduced the acquisition method, which is based on determining the fair value of all acquired assets and liabilities. The fair values of identifiable acquired assets and liabilities in total may or may not equal the purchase price. When the fair value of all identifiable acquired assets and liabilities is less than the purchase price, the difference represents goodwill. If the fair value of all acquired assets and liabilities is more than the purchase price, a bargain purchase would be indicated.

SFAS 141(R) contains the requirements for the initial recognition of goodwill and other intangible assets in business combinations. The Statement also indicates that SFAS 142, *Goodwill and Other Intangible Assets*, provides guidance for the subsequent testing of goodwill for impairment and that SFAS 144, *Testing for Impairment of Long-Lived Assets,* provides guidance the subsequent impairment testing for intangible assets subject to amortization. Accounting standards for the subsequent treatment of goodwill and other intangible assets recognized in a business combination are currently codified in ASC 350, *Intangibles—Goodwill and Other*, and ASC 360, *Property, Plant and Equipment*.

In 2001, The FASB issued SFAS 142, which provides guidance on determining whether goodwill recorded in a business combination becomes impaired in subsequent years, and it sets forth the requirements for the impairment testing. Under SFAS 142, goodwill is tested for impairment annually using a two-step test. The first step is to estimate the fair value of the entity or reporting unit by comparing the fair value to its carrying value (book value). If the fair value is *greater* than book value, goodwill is not impaired. If the fair value is *less* than the carrying value, goodwill may be impaired, and a second step is required.

The second step is to estimate the fair values of all the assets and liabilities of the entity or reporting unit as of the testing date, including the implied fair value of goodwill. This step is similar to the allocation of purchase price under SFAS 141(R). The implied fair value of goodwill is then compared to the carrying value of the goodwill. If the fair value of goodwill is less than the carrying value of goodwill, it is considered to be impaired, and the difference must be written off. More recently, the FASB introduced a qualitative impairment test, dubbed "step zero" in Accounting Standards Update 2011-08, which is covered in Chapter 5.

The application of fair value measurements to nonfinancial assets and liabilities is most often seen in practice in SFAS 141(R), now FASB ASC 805, *Business Combinations*, and SFAS 142, now FASB ASC 350, *Intangibles—Goodwill and Other*. Since these statements were introduced, the FASB has issued clarifications and updates, which are covered in subsequent sections of this chapter, in response to the economic crisis and constituent concerns. In addition, both the accounting profession and the valuation profession have begun projects to determine the best practices for the application of fair value measurements. Many of these projects have taken years to develop and some are still in progress. They are also discussed in later chapters of this book.

Fair Value Measurement

Fair value measurement is discussed from a historical perspective further on in this chapter; the chapter discusses the original issuance of SFAS 157 and it covers the subsequent amendments contained in FASB Staff Positions and Accounting Standards Updates. The next chapter, Chapter 2, "Fair Value Framework from ASC 820," will cover the more important concepts and assumptions for measuring fair value. The chapter will follow ASC 820's contents' sequence and it will provide full references to codification subtopics. In addition, definitions from the FASB's Master Glossary will be provided for quick reference.

Prior to the implementation of SFAS 157 the application of fair value measurements in financial reporting varied among three dozen or more of the pronouncements that required a fair value measurement. These statements referred to different accounting concepts, so over time inconsistencies developed in applying fair value measurements under different statements. With the introduction of SFAS 141 and SFAS 142, some of the more common applications of fair value measurements were in business combinations and the subsequent testing of goodwill and other long-lived assets. These statements required the fair value measurements of assets that were not readily measureable by the marketplace. Preparers of financial statements were concerned about measuring fair value in the absence of quoted market prices. SFAS 157 established a framework for applying fair value measurements. The FASB believed that the implementation of SFAS 157 would improve financial reporting by increasing consistency, reliability, and comparability.

When originally issued, SFAS 157 defined *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."[32] Fair value measurement assumes that the asset or liability can be exchanged in an orderly transaction between market participants who wish to sell the asset or transfer the liability at the measurement date. Fair value measurements arise from an orderly transaction, or one in which there has been exposure to the market for a sufficient period prior to the measurement date to allow for the usual and customary marketing activities for such assets or liabilities. An orderly transaction is not a forced transaction, such as a forced liquidation or a distress sale.[33] By definition a nonactive market is not an orderly market or one in which there is sufficient exposure to the market for usual and customary marketing activities. Thus, a price indicated in a nonactive or illiquid market would likely not be an indication of fair value. SFAS 157 introduced or expanded upon several important topics, as it

- Revised definition of fair value
- Discussed the issue of price in the measurement
- Defined market participants

- Expanded on the concept of principal market or most advantageous market
- Introduced the concept of defensive value
- Described valuation technique
- Introduced the fair value hierarchy
- Expanded required disclosures

These concepts, as updated for convergence with IFRS, are discussed more fully in Chapter 2.

As previously mentioned, SFAS 157's full implementation was delayed by the FASB. SFAS 157 was originally supposed to be effective for fiscal years beginning after November 15, 2007. However, on November 12, 2008, a few days before the statement was to become fully effective, the FASB delayed implementation for nonfinancial assets and liabilities.[34] These nonfinancial assets and liabilities are related to goodwill, business combinations, and discontinued operations, as well as to some nonfinancial intangible assets. One of the reasons for delay was that preparers of financial statements felt they did not fully understand the implications for the statement's implementation.

The statement was fully implemented for fiscal years beginning after November 15, 2008. Although the FASB agreed to adopt the one-year delay, it encouraged the earlier adoption.

FAIR VALUE ACCOUNTING AND THE ECONOMIC CRISIS

Beginning in the latter part of 2006, an increase in the general level of interest rates caused a sharp rise in the delinquency and default rates by subprime rate mortgage borrowers. Most of the underlying subprime mortgages were based on adjustable rates. As interest rose, many borrowers were unable to make the higher interest payments on their mortgages. As a result, the default rates in subprime mortgages increased dramatically. The rise in interest rates also contributed significantly to a decline in the overall housing market, which compounded the impact of the defaults caused by limited options for sale of the underlying real estate by the defaulter.

As an increasing number of subprime mortgage borrowers began to default, many financial institutions and investment banks holding mortgage-backed securities based on subprime mortgages began to experience uncertainty about the reliability of cash flows from these investments, which further eroded their perceived value. As the level of defaults increased, rating agencies significantly downgraded these subprime mortgage securities. The downgrades caused other investors and lenders to refrain from investing in mortgage-backed securities. The lack of a secondary market created a "liquidity crisis," which began to spread throughout the financial markets. The risk of defaults in the underlying mortgages caused the secondary markets for securitized mortgages to freeze, which impacted a wide range of commercial and investment banks that held these securities.

Mark-to-Market Accounting

At the center of this liquidity crisis was an accounting issue: How should the holders of mortgage securities measure the value of these debt securities for financial reporting? To complicate matters, many of the entities had already elected the *Fair Value Option* provided by SFAS 159, which permitted entities to measure most financial assets and liabilities at their respective fair values in fiscal years beginning after November 15, 2007. The *Fair Value Option* incorporates the definition of fair value as presented in SFAS 157, which includes features such as the fair value hierarchy, market participant assumptions, and the preference for observable inputs.

Among the accounting questions at the center of the financial crisis were these two: What is the fair value of the securitized subprime mortgages that financial institutions and other entities should report on their balance sheet? When the market is considered distressed, what is the appropriate level for disclosure in the fair value hierarchy?

Critics of fair value measurement believed that the credit crisis was made much greater by the mark-to-market accounting of financial institutions that had invested in the securitized subprime debt. The criticism of fair value accounting was based on an apparent difference between the market value of certain securities in distressed markets and the value indicated by holding the securities to maturity. The central issue was whether the fair value of these securities would be the depressed price indicated by the market or the value indicated by the securities' expected future cash flows discounted to the present at a risk-adjusted rate of return.

Many called for suspension or revision of SFAS 157 during the economic crisis. However, the Center for Audit Quality reaffirmed its position on the relevance of fair value measurements, saying,

> Suspending fair value accounting during these challenging economic times would deprive investors of critical financial information when it is needed most. Investors have a right to know the current value of an investment, even if the investment is falling short of past or future expectations.[35]

Application of Fair Value Accounting in Illiquid Market

In response to widespread public criticism of mark-to-market accounting, the SEC Office of the Chief Accountant and FASB Staff released a statement entitled "Clarifications on Fair Value Accounting" on September 30, 2008.[36] The statement responded to several questions raised by the credit crisis:

- Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?

  Yes. When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable.
- Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?

  The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

- Can transactions in an inactive market affect fair value measurements?

  Yes. A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used (generally without adjustment). Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative.

On October 10, 2008, the FASB followed the SEC's lead and issued FASB Staff Position 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active,* which further clarified assumptions to be used in measuring fair value in circumstances where there may not be a market price. FSP 157-3 reinforced the fair value measurement concepts introduced by SFAS 157 and reinforced the guidance contained in the SEC's and FASB's joint statement clarifying fair value accounting. Its main points include:

- Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales.
- The use of the reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.
- Broker (or pricing service) quotes may be an appropriate input when measuring fair value but are not necessarily determinative if an active market does not exist for the financial assets.[37]

FSP 157-3 was superseded approximately six months later by FSP 157-4, which was one of the FASB's Credit Crisis Projects which is covered after the following section.

SEC Study on Mark-to-Market Accounting

The Emergency Stabilization Act of 2008 required the SEC to conduct a study on mark-to-market accounting and to focus on the provisions of SFAS 157 that apply to financial institutions. Section 133 of the Act called for a study that would specifically consider:

- The effects of fair value accounting standards on a financial institution's balance sheet
- The impacts of fair value accounting on bank failures in 2008
- The impact of fair value standards on the quality of financial information available to investors
- The process used by the FASB in developing accounting standards
- The advisability and feasibility of modifications to fair value standards
- Alternative accounting standards to those provided in SFAS 157

On December 30, 2008, the SEC's Office of the Chief Accountant and Division of Corporate Finance delivered a report to Congress recommending against the suspension of fair value accounting standards. Among key findings, the report notes that investors generally believe fair value accounting increases financial reporting transparency and facilitates better decision making. The report also observes that fair value accounting did not appear to play a meaningful role in the bank failures that occurred in 2008. Rather, the report indicated that bank failures in the United States appeared to be the result to growing credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence.[38]

The SEC study on mark-to-market accounting suggested that "additional measures should be taken to improve the application and practice related to existing fair value requirements." The SEC study also recommended, "fair value requirements should be improved through development of application and best practices guidance for determining fair value in illiquid or inactive markets."[39]

The FASB's Credit Crisis Projects

The FASB added a new project to its agenda in February 2009, in response to the recommendations contained in the SEC study on mark-to-market accounting and based on input from the FASB's Valuation Resource Group. The project was intended to improve the application guidance used to determine fair values and disclosures for fair value estimates. This project initiative evolved into what the FASB refers to as the Credit Crisis Projects, which include:

- FSP 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, provided additional guidance for measuring fair value in turbulent markets. It was issued in April 2009 in an expedited standards-setting process and in response to pressure from the SEC. The guidance provided by this FASB Staff Position emphasized that the objective of a fair value measurement is to determine the price that would be received when selling the asset in an orderly transaction between market participants under current market conditions. Under FSP 157-4, the preparer first must conclude whether there has been a significant decrease in the level of volume and activity in the market. If so, the preparer must then determine whether the transaction is orderly. Prices from orderly transactions must be considered in the fair value measurement; although adjustments to the price may be appropriate. If the transaction is not orderly, little weight should be placed on the price when determining fair value. FSP 157-4 has been incorporated into FASB ASC 820 and its requirements are covered in more detail in Chapter 2.
- FSP 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, provided the criteria that indicate when a debt security is permanently impaired, and it contained new provisions for the recognition of the impairment. This expedited standard was issued simultaneously with FSP 157-4 in April 2009. Current guidance is available at FASB ASC 320, *Investments—Debt and Equity Securities*, at 320-10-35-17 to 30.
- FSP 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, improved the transparency and quality of fair value disclosures and introduced new requirements for disclosures in interim financial statements. This expedited standard was also issued in April 2009 and is discussed further in the next section. FSP 107-1 has been superseded. Current guidance is available at FASB ASC 320, *Investments—Debt and Equity Securities*, in the Disclosure subtopic at 320-10-50.

- ASU 2009-05, *Measuring Liabilities at Fair Value*, was originally proposed as FSP FAS 157-c, and then as FSP FAS 157-f. This credit crisis issue received a significant amount of attention and public comment. It addresses one of the more contentious aspects of fair value measurement—namely, its application to liabilities. The requirements of ASU 2009-05 have been incorporated into ASC 820 and are discussed in Chapter 2.
- ASU 2009-12, *Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)*, is discussed in Chapter 11, "Fair Value Measurements of Private Equity and Other Alternative Investments."
- ASU 2010-06, *Improving Fair Value Measurements Disclosures*, was issued to improve transparency and to provide more information about the inputs to fair value measurements. The improvements will be included in the Disclosures section of Chapter 2, "Fair Value Measurement Standards and Concepts" from ASC 820.

A final credit crisis project with relevance to fair value measurement was Recoveries of Other-Than-Temporary Impairments (Reversals). The FASB decided to consider whether to allow an entity to recover, through earnings, a previously recognized other-than-temporary impairment loss on certain financial instruments. The Board decided to consider this topic through its work on the joint FASB/IASB project Financial Instruments: Improvement to Recognition and Measurement.[40] The FASB recently issued ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall*, to provide clarification on a number of issues related to fair value measurement of financial instruments.[41]

Financial Crisis Advisory Group (FCAG)

In response to the financial crisis, the FASB and IASB formed a Financial Crisis Advisory Group in early 2009. The group is comprised of senior business leaders both within and outside the accounting profession with broad experience with international financial markets. The purpose of the group is to advise both boards about standard-setting implications of:

- The global financial crisis
- Potential changes to the global regulatory environment[42]

The mission of the group is to provide recommendations to enhance transparency and reduce complexity in financial reporting in an effort to serve the financial markets and restore investor confidence in those markets. The group conducted several advisory meetings throughout 2009 and 2010 to address:

- Areas in which financial reporting helped identify issues of concern, or may have created unnecessary concerns during the credit crisis
- Areas in which financial reporting standards could have provided more transparency to help anticipate the crisis or respond to the crisis more quickly
- Whether priorities for the IASB and the FASB should be reconsidered in light of the credit crisis

- Potential areas that require future attention of the IASB and the FASB to avoid future market disruption
- The implications of the credit crisis for the interaction between general purpose financial reporting requirements for capital markets and regulatory reporting, particularly for financial institutions
- The relationship between fair value and off-balance-sheet accounting and the current crisis, both during and leading up to the crisis
- The findings and relevance of conclusions of various studies underway, including the U.S. Securities and Exchange Commission study under the Emergency Economic Stabilization Act of 2008
- The need for due process for accounting standard setters and its implications on resolving emergency issues on a timely and inclusive basis
- The independence of accounting standard setters and governmental actions to the global financial crisis[43]

The Group published its recommendations on July 28, 2009. The report is organized into four main principles, and contains recommendations to improve the functioning and effectiveness of global standard setting. In his comments about the report, Hans Hoogervorst, the Co-Chairman of the FCAG, emphasized the importance of broadly accepted accounting standards that are the result of thorough due process. He said, "The report highlights the importance but also the limits of financial reporting. Accounting was not the root cause of the financial crisis, but it has an important role to play in its resolution."[44]

THE FASB AND IASB CONVERGENCE PROJECT

For some time, the FASB and IASB (or the "Boards") have recognized the need for "a single set of high-quality, international accounting standards that companies worldwide would use for both domestic and cross-border financial reporting."[45] With increasing global economic activity, it was believed that a single set of international accounting standards were needed to support healthy global capital markets and meet the needs of investors worldwide. The FASB and IASB had been jointly working on a project to converge U.S. GAAP with IAS since 2002. Although the Convergence Project was eventually halted due to many outside factors, the Project did lead to the convergence of standards related to fair value measurement and business combinations. In addition, the Boards discussed issues related to convergence of standards on impairments. Since the Convergence Project impacted Fair Value Measurements under both GAAP and IFRS, it is helpful to understand the milestones.

At a September 2002 meeting in Norwalk, Connecticut, the FASB and IASB agreed to "use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their work program to ensure that once achieved, compatibility is maintained."[46] The project has become known as the Convergence Project.

In February 2006, the Boards issued what has become known as a Memorandum of Understanding (MoU). The MoU was based on three joint principles:

- Convergence of accounting standards can best be achieved through the development of high-quality, common standards over time.
- Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead, a new common standard should be developed that improves the financial information reported to investors.
- Serving the needs of investors means that the Boards should seek convergence by replacing standards in need of improvement with jointly developed new standards.[47]

The 2006 MoU also prioritized the joint work into three groups: (1) short-term convergence projects, (2) active agenda projects, and (3) future convergence projects. The short-term convergence projects focused on eliminating a few major differences between U.S. GAAP and IFRS and each of the Boards focused on topics regarded as candidates for improvement. While the FASB examined the fair value option, research and development, and subsequent events, the IASB examined borrowing costs, joint ventures and segment reporting, as well as other topics. The FASB and IASB also planned to work jointly to improve current accounting practices. The active agenda projects included seven projects the Boards were already working on: business combinations, consolidations, fair value measurement, distinguishing liabilities and equity, performance reporting, post-retirement benefits, and revenue recognition. The final group included the Boards' future agenda projects: derecognition, financial instruments, intangible assets, and leases.[48]

A significant milestone was achieved by the Boards in 2007 with the first issuance of a joint standard entitled *Business Combinations*. Although they are not perfectly identical, SFAS 141(R) and IFRS 3 provide similar guidance for the application of the acquisition method to business combinations. The Boards' guidance reflects concurrence on the more significant issues relating to accounting for business combinations. Codified in ASC 805, SFAS 141(R) strengthened the fair value measurement focus when accounting for a merger or acquisition. ASC 805 is perhaps the most significant accounting standard requiring fair value measurement for nonfinancial assets and liabilities, and it is a primary focus of this book. The application of ASC 820 concepts to business combinations will be discussed in more depth in Chapter 3, "Business Combinations," and will be illustrated throughout the remainder of the book.

In April 2008, the Boards updated the Memorandum of Understanding and noted that a number of the short-term convergence projects had been completed including the fair value option, research and development, borrowing costs and segment reporting. Although *Business Combinations* was the only joint project that had been completed, the Boards noted that significant progress had been made in a number of other projects. The Boards set a goal of completing their joint projects by 2011.[49]

In another milestone, the FASB and IASB completed a joint project on fair value measurement. The FASB issued ASU 2011-04 and the IASB issued IFRS 13, *Fair Value Measurement*, in an effort to harmonize the concepts surrounding the measurement of fair value and align disclosure requirements. It is important to note that the guidance does not extend the use of fair value measurement either in the United States or internationally. Instead, it improves the guidance on how fair value should be measured and disclosed in situations where it is already required or permitted in existing accounting pronouncements.[50]

ASU 2011-04 provides clarifications relating to the concepts of highest and best use, the measurement of an entity's equity interest, and qualitative disclosures for unobservable inputs. It also changes the fair value measurement principles for financial instruments managed within a portfolio and for the application of premiums and discounts in the fair value of a reporting unit. In addition, ASU 2011-04 requires additional disclosures for Level 3 measurements, among other disclosures.[51]

IFRS 13 adopted several important fair value measurement concepts from SFAS 157, including an exit price assumption, the principal market focus, and the exclusion of blockage discounts. In addition, IFRS 13 includes U.S. GAAP fair market value concepts included in subsequent FASB fair value measurement guidance for inactive markets and for measuring liabilities at fair value.[52]

Perhaps the most interesting change brought about by convergence of fair value measurement and the issuance of ASU 2011-04 is that some disclosures have been eliminated for nonpublic companies.[53] The FASB made these changes in response to constituent feedback and in an effort to reduce the reporting burden for private companies. The details are covered in the Disclosure section of Chapter 2.

In an April 2011 joint podcast, David Tweedie, chairman of the IASB, and Leslie Seidman, chairman of the FASB, summarized the progress that the Boards had made on the convergence project to date; they discussed the overarching objectives of the project and they announced an extension of the target deadline. The chairmen emphasized that the goal of convergence is high quality standards that allow ample time for outreach to constituents. He added that input from interested parties has allowed the Boards to develop standards in a collaborative manner. As of April 2011, the Boards had yet to complete their work on leasing, revenue recognition, financial instruments, and insurance. Therefore, they announced that the original June 2011 target for convergence had been extended to the end of 2011. Although the 2011 target was not met, convergence efforts continued. However, due to certain external factors, the Project was eventually put on hiatus. In a speech to the FASB@40 conference on September 12, 2013, FASB Chairman Russ Golden provided his views on the priorities of the organization. Relating to convergence, Mr. Golden noted that the process for achieving convergence of global accounting standards "will change." Mr. Golden further noted that "FASB's first priority is to improve the financial reporting for the benefit of investors and other users of financial information in U.S. capital markets."[54] The SEC's role in deciding whether to accept IFRS for U.S. financial reporting is discussed in the following section.

The SEC and IFRSs

In 2007, as a result of the progress achieved by the FASB and IASB toward convergence, the SEC decided that it would no longer require reconciliation of IFRSs based financial statement to U.S. GAAP for non-U.S. companies registered to issue securities in the United States. In a parallel move, the European Commission decided in 2008 that listed companies can prepare financial statements using another country's GAAP, provided that the country's GAAP is subject to convergence with IFRS and provided that the country's GAAP has been deemed equivalent to IFRS. As of 2008, U.S., Canadian, and Japanese companies can comply with EU financial reporting requirements using their own countries' versions of GAAP.[55] These SEC and European Commission developments effectively create two sets of similar, but not completely convergent standards in the United States and in the European Union. These changes provide flexibility to foreign companies, however, domestic corporations registered in the United States and the European Union do not currently enjoy the freedom to choose between U.S. GAAP and IFRS.

The Original Proposed Roadmap

In 2008 the SEC issued a roadmap to advance the adoption of IFRSs for U.S.-based reporting entities, saying, "Because IFRSs has the greatest potential to become the global standard of accounting, we believe it is in the best interest of U.S. investors, U.S. issuers, and U.S. markets to consider mandating reporting under IFRSs in the United States as well."[56] The roadmap lists milestones to be achieved toward the goal of requiring that SEC registered companies use IFRSs for financial reporting purposes.

1. *Improvements in accounting standards*. Under this first milestone, the SEC will evaluate the progress made by the boards in developing standards under the Memorandum of Understanding that are "high quality and sufficiently comprehensive."[57]
2. *Accountability and funding of the IASC Foundation*. A new, permanent funding arrangement is needed for the International Accounting Standards Committee (IASC) because traditionally, participants have provided funding in the capital markets on a voluntary basis. The new system of funding must be broad based, compelling, open-ended, and country specific. The SEC also believes the IASC should have more oversight from securities authorities similar to the SEC's oversight of the FASB in the United States.
3. *Improvement in the ability to use interactive data for IFRSs reporting*. The SEC recently required that financial statement filers use eXensible Business Reporting Language (XBRL) to submit financial information. The SEC wants IFRSs financial statement preparers to use a similar interactive data format.
4. *Education and training*. As U.S. GAAP is transitioned into IFRSs, the SEC recognizes that accountants, investors, auditors, and other users of the financial information will need to be retrained in IFRS, and the SEC recognizes that this training effort would have to take place prior to the adoption of IFRSs in the United States.
5. *Allowance for limited early use of IFRS where this would enhance comparability for U.S. investors*. The SEC has made several proposals for the early use of IFRS by certain reporting entities where the adoption of IFRS allows better comparison of financial data.
6. *Anticipated timing of future rulemaking by the commission*. The SEC plans to perform a comprehensive review of all SEC rules and to make recommendations for amendments to those rules so that IFRS can be used for registration and reporting under the Exchange Act and the Securities Act.

7. *Implementation of the mandatory use of IFRS*. The mandatory use of IFRS would be implemented in stages, beginning in 2014. The SEC would require filers to provide three years of financial information in the first year of implementation. For example, large accelerated filers would be required to file financial statements using IFRS for the fiscal years 2012 through 2014.[58]

The Work Plan

In response to public feedback on the Proposed Roadmap and in response to the G-20's call for standards setters to increase their efforts to create a single set of high quality, global accounting standards in the wake of the global economic crisis, the SEC directed its staff to formulate a plan for U.S. financial statement issuers to transition to IFRS. The February 2010 Work Plan addressed the following areas:

- Sufficient development and application of IFRS for the U.S. domestic reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRS
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, litigation contingencies
- Human capital readiness[59]

The purpose of the work plan is to provide the SEC with sufficient information to decide "whether, when and how our current financial reporting system for U.S. issuers should be transitioned to a system incorporating IFRS."[60]

The SEC staff released two papers in late 2011 in connection with the execution of the work plan. The first addressed whether IFRS is sufficiently developed and of a high enough quality for application in the United States. The paper, "A Comparison of U.S. GAAP and IFRS," is a principle level evaluation organized by ASC Topic that highlights the differences between the two sets of standards. The staff's scope excluded joint FASB/IASB projects underway under the MoU. The second paper, "An Analysis of IFRS in Practice," summarizes the staff's analysis of 183 companies that prepare IFRS financial statements, including some that are SEC registrants. The staff noted two themes from their analysis of financial statements that are prepared in compliance with IFRS. One is that transparency and clarity could be enhanced through better disclosures. The other is that diversity in application permitted under IFRS made comparability across countries and industries more challenging.

The SEC made substantial progress on the work plan through the end of 2011; however, there are two significant open items. First, the FASB and IASB have not completed all the convergence projects.[61] The FASB's technical plan and project update web page indicates that joint FASB/IASB projects underway include financial instruments, hedging, investment companies, revenue recognition, leases, and insurance contracts.[62] The second open item is a governance strategy for the IASB. The International Accounting Standards Committee's Foundation Monitoring Board, which includes representatives from the SEC and the Board of Trustees of the Financial Accounting Foundation, which oversees the FASB, are both in the process of reviewing governance strategies for the IASB. The focus of their work is to enhance the IASB's structure to promote an independent, accountable-standards-setting body. The SEC is expected to issue a report in 2012 summarizing the efforts required to complete the work plan.[63]

The SEC's Deputy Chief Accountant Paul A. Beswick delivered a speech to the AICPA on December 5, 2011, addressing convergence. In his closing remarks he indicated that the goal of a single set of high-quality global accounting standards may not be achievable if national standards setters such as the FASB and SEC have the ability to deviate from IASB standards. Then, he asked, "Would it better to be 90 percent converged and understand the differences, or should the objective be abandoned?"[64]

Condorsement

Although the SEC has not reached a final decision whether to incorporate IFRS into the U.S. financial reporting system, it has begun to explore possible incorporation approaches. One such approach, dubbed "condorsement," is discussed in a SEC Staff Paper published May 26, 2011, "Exploring a Possible Method of Incorporation," and is part of the SEC's Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers.

Other jurisdictions have incorporated IFRS into their reporting systems either by full adoption of IFRS as issued by the IASB without intervention, or by applying a national incorporation process that considers existing laws and regulations and leads to adoption of IFRS, or a local variation of IFRS. National incorporation processes can generally be broken down into convergence approaches or endorsement approaches.

Countries that follow convergence approaches maintain their local standards, but make efforts to converge those standards to IFRS over time. The United States and China are currently following convergence approaches. Countries following an endorsement approach incorporate individual IFRS into their local standards, with varying degrees of modification. The European Union and Australia generally follow an endorsement approach.

The SEC Staff's potential framework is basically an endorsement approach with a longer, phased transition period following a convergence approach; thus "condorsement." Under the Staff's potential framework, the transition plan would begin with the Memorandum of Understanding projects that the FASB and IASB have jointly undertaken and committed to completing in 2011. These projects include financial instruments, revenue recognition, leases, other comprehensive income, fair value measurement, netting of derivatives, and consolidation of investment companies.

The second phase would incorporate those standards currently on the IASB's standard-setting agenda. The FASB would participate in the standard-setting process, but current U.S. GAAP would remain in place until the new standards are issued. The third category includes IASB Standards that are not slated for change in the near future, and would require further development of a transition plan.

The SEC Staff believed that following their potential condorsement framework for incorporation would help U.S. constituents manage the transition and would provide the FASB flexibility to meet constituent needs. Gradual implementation would potentially be less costly and would permit coordination with ongoing standard-setting activity.

Another important benefit is that the possible SEC Staff method incorporates IFRS into U.S. GAAP, which preserves U.S. GAAP as the basis for financial reporting in the United States. It also preserves the SEC's authority over U.S. accounting standard setting and maintains the FASB role in protecting U.S. constituent's interests in the development of high-quality standards. The FASB would provide input and support to the IASB, but would retain the ability to modify or supplement IFRS to protect U.S. interests.[65]

In July 2012, the SEC staff issued what it termed its "final" report on the convergence of U.S. GAAP and IFRS titled, "Work Plan for Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers." In the report, the staff concluded that there were still a number of unresolved issues of convergences, including:

- the diversity in how accounting standards, including IFRS, are interpreted,
- applied and enforced in various jurisdictions around the world,
- the potential cost to U.S. issuers of adopting or incorporating IFRS;
- investor education;
- and governance.[66]

Although SEC staff noted the differences in their final report there was no recommendation for future plans for the eventual convergence of the standards.

THE FUTURE OF FAIR VALUE MEASUREMENT

Whether full convergence of U.S. GAAP with international standards is ever achieved, financial reporting standards are likely to continue their parallel courses of harmonized development. Although the convergence of fair value measurement standards has been largely completed, there will likely be future clarifications and harmonization of the few remaining differences.

In contrast, disclosures about fair value measurement will likely take two divergent paths. Although there has been a consistent trend toward more disclosure for public companies, which is likely to continue, the same cannot be said for nonpublic companies. In fact, IFRS contain a separate set of reporting standards for private entities entitled International Financial Reporting Standards for Small to Medium-sized Entities (IFRS for SMEs). The self-contained 230-page set of standards is designed to reduce the financial reporting burden for nonpublic companies. The FASB has decided to follow the IASB's lead, and established a Blue Ribbon Panel to address how accounting standards can best meet the needs of private company financial statement users in the United States.

The Panel concluded that the current accounting standards-setting system in the United States is deficient in two significant ways. First, standard setters do not understand decision-useful information from the perspective of private company financial statements users. Second, standard setters have not weighed the costs and benefits of GAAP for private company financial reporting. These shortcomings have led to standards that lack relevance for many users and to standards with a level of complexity that is a burden for private companies and their CPA practitioners. Fair value measurement and goodwill impairment are two of the current accounting standards cited by the report as contributing to the problem.

The Blue Ribbon Panel's report considered alternative models and structures for developing accounting standards for private companies. The Panel considered a model similar to the IASB's model that has separate International Financial Reporting Standards for Small to Medium-sized Entities (IFRS for SMEs), but rejected a ground-up creation of separate, stand-alone statements for private companies. Instead, the Panel decided upon and recommended a U.S. GAAP model with exceptions and modifications that respond to the needs of the private company sector. In addition, the Panel recommended that a new, separate accounting standards board be created to determine exceptions and modifications to U.S. GAAP. These new standards will be discussed in subsequent chapters.

Accounting standards setters are also considering whether internally generated intangible assets should be recognized on the financial statements. IFRS 38 allows for the recognition of certain internally generated intangible assets in a development phase rather than research phase, other than "internally generated brands, mastheads, publishing titles, customer lists and similar items." Although these limited intangible assets are recognized at cost initially, IFRS allows for remeasurement at fair value if there is a reference to an active market.[67]

The European Financial Reporting Advisory Group (EFRAG) is a "private association established with the encouragement of the European Commission" and "to promote views in the field of financial reporting." EFRAG is undergoing a research project on better information on intangible assets.[68]

Research indicates that investors require more complete information in financial reporting. Since current financial reporting does not provide information for almost two-thirds of the market capitalization of publicly traded companies, perhaps accounting standard setters will begin to focus on internally generated intangible assets and their contribution to overall valuations in the interest of providing more complete transparent information for investors, which should lead to even greater use of fair value as a unit of measurement in financial reporting.

FAIR VALUE QUALITY INITIATIVE FOR VALUATION SPECIALISTS

Fair value continues to be widely used as a unit of measurement under both U.S. GAAP and IFRS in financial reporting. Fair value, while providing useful information to the users of financial information, often involves the use of complex financial models, comprehensive valuation techniques, and typically incorporates some form of judgment into the measurement. Since the fair value measurement techniques are, in certain circumstances, beyond the expertise of management, outside valuation specialists are retained to assist with the fair value measurement. Management subsequently uses the work product of the outside specialist as audit evidence in financial reporting. Even though an outside specialist prepares the work, management still maintains responsibility for the fair value measurement.

In Prepared Remarks for the 2011 AICPA National Conference on Current SEC and PCAOB Developments, the then–Deputy Chief Accountant of the SEC, Paul Beswick, expressed concern about the then-existing structure of the valuation profession. Mr. Beswick noted, “Valuation professionals stand apart from other significant contributors in the financial reporting process for another reason, their lack of a unified identity.” Mr. Beswick went on to suggest, “I think one potential solution to consider is whether there should be, similar to other professions, a single set of qualifications with respect to education level and work experience, a continuing education curriculum, standards of practice and ethics, and a code of conduct. One could also contemplate whether a comprehensive inspection program and a fair disciplinary mechanism should be established to encourage proper behavior and enforce the rules of the profession in the public interest.”[69]

In response to Mr. Beswick’s suggestions, the Appraisal Foundation hosted a series of roundtables for the valuation profession to discuss these concerns. As a result of these discussions, several organizations, including not-for-profit valuation professional organizations (VPOs), nonmembership VPOs, leaders of valuation practices of international accounting and consulting firms and others formed what became known as the Fair Value Quality Initiative to address the concerns of regulators about the profession. The Fair Value Quality Initiative formed several task forces that developed four workstreams to create an infrastructure to provide a more unified profession for valuations for financial reporting. The four workstreams included:

1. Governance and coordination
2. Performance requirements
3. Qualifications
4. Quality control[70]

There were many significant outcomes of this initiative. The first is the creation of the Certified in Entity and Intangible Valuations (CEIV) credential, which is a single credential offered by the American Institute of Certified Public Accountants (AICPA), American Society of Appraisers (ASA), and Royal Institution of Chartered Surveyors (RICS). The CEIV is intended for valuation professionals who provide valuations for financial reporting purposes. Although the CEIV can be obtained through one of three VPOs, each organization has a standard education and experience requirements as a pathway to obtain the CEIV. The three VPOs developed a unified exam in which a candidate from any of the three organizations must pass in order to ultimately obtain the credential. Additional information about the CEIV can be obtained at https://ceiv-credential.org/.

The second and perhaps in some ways even more significant outcome of the Fair Value Quality Initiative is the development of the Mandatory Performance Framework (MPF) and its companion document, the Application of the Mandatory Performance Framework (AMPF). The MPF is designed as a performance framework to assist valuation specialists with the determination of “how much” work and documentation needs to be completed for valuations for financial reporting. The MPF and AMPF are discussed in further detail in Appendix 1A to this chapter.

CONCLUSION

Fair market value is a concept that is widely used in the United States for legal and tax matters and its measurement has been debated for over a century. Fair value is a standard of measurement that has been permitted or required in certain situations in U.S. GAAP for about 40 years. Fair value is "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."[71] Guidance for measuring fair value currently appears in ASC 820.

ASC 820 has evolved since it was originally issued as SFAS 157 in 2006. The economic crisis forced the FASB to reconsider some SFAS 157's more controversial aspects such as measuring fair value in inactive markets, measuring liabilities, and the adequacy of disclosures. The initial process of convergence of U.S. GAAP and IFRS also led to a refinement of many of the terms associated with fair value measurement such as highest and best use, market participants, and exit price. In addition, the convergence process shaped required disclosures by requiring more information about the unobservable inputs to the measurement, but by reducing the required disclosures for nonpublic companies. The issuance of ASU 2011-04, which is now codified under ASC 820, marked the end of the FASB's fair value measurement refinement project.

The valuation profession with the introduction of the CEIV credential and the issuance of the Mandatory Performance Framework has led to more consistent, higher-quality fair value measurements, which should enhance the public trust in financial reporting. The technical aspects of fair value measurements continue to evolve. While the FASB explores the cost-benefit of fair value measurements in various circumstances, it appears that the accounting and reporting requirements for fair value measurement will continue to exist in their present form for the foreseeable future.

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