

Is Fair Value Equal to Fair Market Value?

(Is GAAP Fair Value a Relevant Value Measure
for Ad Valorem Property Tax Purposes?)

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Discussion Outline

- GAAP Primer – Who Sets GAAP?
- GAAP Primer – Hierarchy of GAAP
- GAAP Primer – When Does Fair Value Apply?
- GAAP Definition of Fair Value
- Common Definition of Fair Market Value
- Fair Value and Fair Market Value Definitions are Similar
- Valuation Procedures and Assumptions are Different
 - Level of Account Differences
 - HABU Differences
 - Allowed Methodology Differences
 - Other Differences
- Illustrative Example of FV vs. FMV Differences
- Summary and Conclusion



Introduction

Why is this topic relevant to NAPTR-TEC?

- Property tax assessors look for the following types of transactions –
 - subject taxpayer (TP) is acquired and the TP assets are restated to FV
 - subject TP acquires a target company and the target company assets are restated to FV
 - industry competitor to the TP is acquired and its assets are restated to FV



Introduction (cont.)

- Property tax assessors will use these FV valuations as follows –
 - accept the FV of TP assets as the FMV of TP assets
 - calculate FV to book value (assets) multiple from other transactions and apply that FV/BV multiple to TP tangible assets
 - calculate FV to BV (equity) multiple from other transactions and apply that FV/BV multiple to TP assets or TP equity
 - use FV/BV (equity) transaction multiples to conclude there is no economic obsolescence in the TP or the industry
- These issues apply to centrally assessed unit value taxpayers, but they also apply to some locally assessed summation value taxpayers



GAAP Primer – Who Sets GAAP?

- the Financial Accounting Standards Board (FASB) sets US generally accepted accounting principles (GAAP)
- the International Accounting Standards Board (IASB) sets international financial reporting standards (IFRS)
- IFRS are adopted in 110 countries in Europe, Africa, Asia, South America, and North America (except US)
- the FASB and IASB are working toward GAAP convergence
- for the last several years, all GAAP changes have been approved by both organizations
- currently, there are nearly identical fair value measurement and disclosure provisions



GAAP Primer – Who Sets GAAP? (cont.)

- on 5/12/11, the IASB issued IFRS 13 titled *Fair Value Measurement* and the FASB issued ASU 2011-04 titled *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRS*
- now, fair value is defined the same, acceptable methodology is nearly identical, and disclosure requirements are largely the same



IFRS and US GAAP Fair Value Definition

“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.”



2011 FV GAAP Changes

- IFRS 13 prescribes the same three-level hierarchy of FV measurement methods found in US GAAP
- IFRS 13 provides guidance on:
 - making assumptions about markets and market participants
 - applying adjustments to actual market transaction prices
 - measuring FV when markets are inactive
- FASB accounting standards codification (ASC) 820 changes (from ASU 2011-04) clarify:
 - applying HABU and valuation premise in FV measurements
 - measuring FV of shareholders' equity instruments – for comp purposes
 - making FV measurement disclosures



US GAAP Hierarchy

ASC 105-10 identifies four levels of GAAP hierarchy:

1. Level 1 (highest level)

- FASB statements and interpretations
- FASB accounting standards updates (ASU)
- APB opinions
- AICPA accounting research bulletins

2. Level 2

- FASB technical bulletins (FTB) FASB interpretations (FIN), FASB staff positions (FSP)
- AICPA industry audit and accounting guides
- AICPA SOPs

3. Level 3

- AICPA ACSEC technical bulletins
- FASB EITF consensus positions

4. Level 4 (lowest level)

- FASB staff implementation guides



When Does Fair Value Apply in GAAP?

ASC	Fair Value Topic
ASC 805-20-30	Business combinations—identifiable assets and liabilities
ASC 815-10-50	Derivatives and hedging—disclosures
ASC 820	Fair value measurements and disclosures
ASC 825-10-25	Financial instruments—the fair value option
ASC 350	Goodwill impairment
ASC 360	Other long-lived asset impairment
ASC 718	Share-based compensation



Fair Value Definitions

- Fair value is defined in ASC 820 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.”
- An “orderly transaction” is a hypothetical transaction assumed to take place on the measurement date with the subject asset having been exposed to the market for the usual and customary period of time for transactions involving such assets in order to provide sufficient time for marketing activities.
- An orderly transaction is not a sale where the seller is under duress (e.g., a forced liquidation or distress sale).



Fair Value Definitions (cont.)

- Fair value measurements are considered from the perspective of a market participant that already holds the asset or owes the liability.
- The objective of measuring fair value is to determine an exit price: the price that would be received to sell an asset or the price that would be paid to transfer the liability.

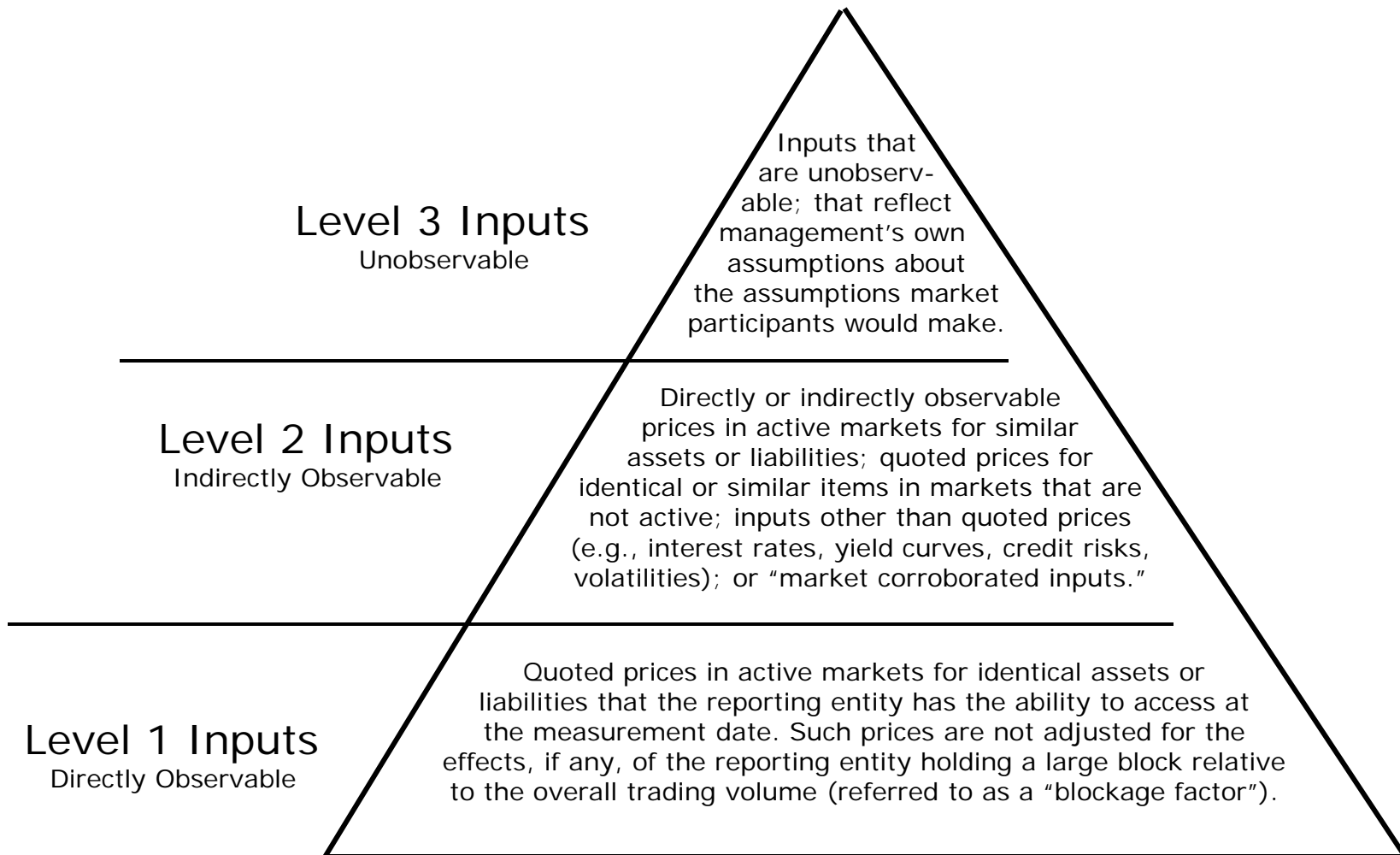


ASC 820 Fair Value Eight Steps

1. Identify the item to be valued and the unit of account.
2. Determine the principal or most advantageous market and the relevant market participants.
3. Select the valuation premise to be used for asset measurements.
4. Consider the risk assumptions applicable to liability measurements.
5. Identify available inputs.
6. Select the appropriate valuation technique(s).
7. Make the measurement.
8. Determine amounts to be recognized and information to be disclosed.



ASC 820 – Hierarchy of Fair Value Inputs



Item Identification and Unit of Account

- The same unit of account at which the asset is aggregated or disaggregated by applying other applicable GAAP is to be used for fair value measurement purposes.
- ASC 820 prohibits adjustment to the valuation for a “blockage factor.”
- The blockage prohibition applies even if the quantity held by the reporting entity exceeds the market’s normal trading volume.



Principal or Most Advantageous Market and Market Participants

- ASC 820 requires the analyst to maximize the use of assumptions (inputs) that are observable from market data obtained from independent sources.
- The analyst is to assume that the asset is exchanged in a hypothetical, orderly transaction between market participants at the measurement date.
- To characterize the exchange as orderly, it is assumed that the asset will have been exposed to the market for a sufficient period of time prior to the measurement date—to enable marketing activities to occur that are usual and customary with respect to transactions involving such assets.



Exit Price

For valuing assets, exit price is the *price* that a reporting entity that holds the asset would hypothetically receive by selling it on the measurement date.



Highest and Best Use

The use of an asset by market participants that would maximize its value or the value of the group of assets in which those market participants would use it. An asset is valued using one of the following premises:

1. In use. This premise is used if the maximum value would be provided to market participants by using the asset in combination with other assets as a group. The asset could be used as it is installed and configured at the measurement date or in a different configuration.

An in-use fair value is based on the price that would be received by the reporting entity on the measurement date in a current transaction to sell the asset along with the other assets in the group using consistent assumptions regarding the HABU of all of the assets in the group.



Highest and Best Use (cont.)

2. In exchange. This premise is used if the maximum value would be provided to market participants from the asset on a stand-alone basis.

An in-exchange fair value is based on the price that would be received on the measurement date in a current transaction to sell the asset individually and not as part of a group of assets.



Market Participants

Buyers and sellers in the principal or most advantageous market for an asset who are:

1. independent of the reporting entity (i.e., other than related parties)
2. knowledgeable to the extent that they have a reasonable understanding about the asset and the transaction based on all available information, including information that is obtainable through the performance of usual and customary due diligence efforts
3. able to buy or sell the asset
4. willing to enter into a transaction for the asset (i.e., they are not under duress that would force or compel them to enter into the transaction)



Most Advantageous Market

- From the standpoint of a reporting entity that does not have access to the principal market, the market in which the reporting entity would sell the asset for the maximum amount or transfer the liability for the minimum amount, taking into consideration the costs of executing the transaction in the respective markets.
- Although transaction costs are considered in making a determine of the market that is most advantageous, such costs are not to be factored into the fair value valuation determined by reference to that market.



Principal Market

- From the standpoint of the reporting entity, the market that it would use to sell the asset that has the highest volume of transactions and level of activity.
- If there is a principal market for an asset, fair value is to be determined by reference to that market, even if the reporting entity could receive a more favorable price in a different market.
- This is the case even if the price is not directly observable and, instead, is determined using a valuation technique with assumptions (inputs) derived from market data.



Fair Market Value Definition

“Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.”¹

¹ Internal Revenue Service Treasury Regulations §20.2031-1(b).



Fair Value Concerns for Property Tax Purposes

HABU

- Most states require the unit HABU assumption of value-in-use
- Fair value requires a separate HABU conclusion for each unit of account

Hypothetical participants vs. hypothetical transaction

- Fair market value assumes a hypothetical buyer and hypothetical seller transaction
- Fair value assumes a hypothetical transaction between a market participant buyer and a known seller (i.e., the current owner seeking an exit price)

Unit of account

- Most states require all centrally assessed taxpayer assets to be valued collectively, as a single operating unit
- Fair value requires a separate valuation for each unit of account—i.e., each general ledger asset account



Fair Market Value for Property Tax Purposes (cont.)

Valuation methods

- Most states allow the valuation analyst to use any (or all) generally accepted valuation approaches and methods
- Purchase accounting GAAP dictates the use of one particular method for each asset category

Disposition costs

- Fair market value requires consideration of make-ready costs, disposition costs, holding period costs, market absorption, etc.
- Fair value considers the exit selling price only—no selling costs or market absorption discount

Regulatory approvals

- Most states recognize that the taxpayer may have to obtain regulatory approval to discontinue utility operations and sell off assets (which affects fair market value)
- Fair value assumes the taxpayer can sell all of its assets on the valuation date without regulatory delay



Fair Market Value for Property Tax Purposes (cont.)

Obsolescence

- Most states recognize that unit-level functional and economic obsolescence should be considered in the valuation
- Only unit of account level obsolescence is considered in a fair value valuation. All unit level obsolescence is assumed to be already included in the purchase price.

Unit valuation

- Many states require the unit valuation principle in the property tax assessment of utility-type properties
- Fair value is based on a summation valuation principle



Fair Market Value for Property Tax Purposes (cont.)

Intangible assets

- Most states require intangible assets to be valued at FMV, between a willing buyer and a willing seller
- Fair value requires consideration of the acquirer's expected use of purchased intangible assets (e.g., software, trademarks, etc. have no FV if the acquirer does not plan to use them)
- Not all intangible assets (e.g., assembled workforce) are recorded under FV GAAP.



Illustrative Railroad Tangible Asset Accounts

- A fair value valuation would consider each of these units of account for real estate and tangible personal property:

Land

Signals

Grading

Main tracks

Tunnels

Siding tracks

Bridges

Yard tracks

Ties

Buildings

Rails

Building improvements

Ballast



Illustrative Railroad Tangible Asset Accounts (cont.)

- A fair value valuation assumes that these tangible assets:
 - can be sold immediately
 - can be immediately absorbed by the market
 - can be sold without regulatory issues
 - can be sold without environmental or other clean-up costs
 - can be sold without selling costs
 - can be sold in a greenfield scenario



Illustrative Railroad Intangible Asset Accounts

- A fair value valuation would consider each of these units of account for intangible personal property:
 - Licenses and permits
 - Regulatory approvals
 - Customer contracts
 - Expected contract renewals
 - Proprietary technology
 - Patents
 - Favorable contracts
 - Trademarks and trade names
 - Trained and assembled workforce
 - Computer software
 - Goodwill
- Fair value considers the acquirer's use of these intangible assets



Summary and Conclusion

- Summarized GAAP fair value measurements
- Fair value and fair market value definitions are similar
- Fair value and fair market value valuation procedures are different
- Differences include:
 - HABU
 - Unit of account
 - Disposal cost assumption
 - Market absorption
 - Unit vs. summation principle
 - Other differences
- Accordingly, fair value is not the same as fair market value
- Fair value should not be used for property tax purposes
- Questions and discussion

