Opinion

FAIR VALUE ACCOUNTING

Its Time Has Come and Gone

BY ALFRED M. KING, CMA, CFM

It's easy to find fault with the present historical cost model used in generally accepted accounting principles (GAAP). Prices change, and the original cost of an asset can be way below (or way above) its value on the open market today. Proponents of fair value accounting, or current value accounting (the terms are often used interchangeably), make the assumption that there is, in practice, a single "current value" for each and every asset. Further, it is asserted, readers of financial statements, not to say management itself, will be able to make *better* decisions if only they had this information. Put a different way, what an asset cost 10 years ago is declared irrelevant in today's environment. The only relevant information, for fair value proponents, is today's value.

MULTIPLE VALUES

Let's start with the first fallacy. We will make a flat assertion: There is no such thing as *the* value of an asset. Instead there can be, and often are, several different values for the same asset.

Take a simple example of a 2003 Ford truck, Model F150, to be used in a construction business. The truck on the dealer's lot has a sticker stating that the manufacturer's suggested retail price (MSRP) is $20,000. Is $20,000 the fair value? If you go into the dealer's place of business and offer the dealer $19,000, you'll soon own the truck. Is $19,000 the fair value? You go to the bank to finance the purchase, and the bank says, "We will lend you $17,500 to buy the truck. If you default on the loan, that is the amount we would receive if we had to sell it." Is $17,500 the fair value? Two weeks later you realize that the truck is too small and you really should have bought a Ford Model F250. You go to the dealer, who has one Model F250 on his lot with a sticker price showing its MSRP is $30,000. The dealer says, "I will give you $21,000 for your Model F150 as the trade-in value on the F250. Give me $9,000 cash and your two-week old F150, and you can have the F250. Is $21,000 the fair value of the F150?

This example, while made up for the article, absolutely reflects current market conditions. Which market is *the* market? After all, the argument of fair value proponents is that "the market" today is more relevant than yesterday's cost. The truth is that there is more than one market for the same asset and hence more than one value. One more simplified example should suffice. Take a one-carat flawless "D" diamond. Starting at the mine, through DeBeers, to a wholesaler, to a retailer, and to a bridegroom for a retail purchase of an engagement ring, the "value" of the diamond will vary by a factor of 300%-400%.

The very first question we, as professional appraisers, ask a prospective client is "What is the *purpose* of the appraisal?" Are you buying, or are you selling? Every manufacturer, every wholesaler, every retailer *must* have a profit margin. Therefore, there *always* will be a difference between the buying price (value) and the selling price (value). As appraisers we can determine one or the other or both. But the fact is that there is a difference.

Now proponents of fair value accounting not only have to argue that "fair value" is more relevant than historical cost, but they also have to specify *which* fair value. For the bank in the above example, the "value" of the F150 for collateral is $17,500. For the contractor considering a trade-in, the "value" of the same F150 is $21,000. This is a $3,500 difference, or some 20%. So fair value accounting isn't just substitution of one number (fair value) for another (historical cost). Which value will be substituted?

If I'm looking at the financial statement of a jewelry wholesaler with a typical markup of 50% of cost (25% of selling price), do I want the wholesaler's cost or what the asset could be sold for at retail? If I'm lending money to the wholesaler, I want one value. If I'm offering to buy the entire business, I may want a different amount. Finally, if I'm the insurance company, I want a third value. These examples could be extended indefinitely.

The conclusion I, as an appraiser, draw is that there will be as great, if not greater, imprecision in fair value accounting as there is with today's historical cost GAAP. Far from providing "better" information, there will have to be so many explanations that most financial statement readers will shake their head in despair and plead, "Give us back good-old historical cost GAAP. With all its faults, at least we understood what we were getting."

CHANGES IN FAIR VALUE

The second major problem with fair value accounting is that values change, they change quickly, and they change both up and down. In an inflationary environment there's an implicit assumption that values always go up. Therefore, the argument goes, historical cost understates fair value. Instant earnings can be created simply by selling off older assets at a profit. Since GAAP requires all asset impairments to be recognized and any overvaluation removed, the only possible error between book value and fair value is a "one-way" street. Fair value, proponents believe, will almost always be higher than historical cost book value.

But if we go to a true fair value basis of financial reporting and all values shown are "current" values, then we are going to find that values can go down just as much as they go up. True believers in fair value argue that this is exactly what they want. They want the "truth." If assets today are worth less than last year, so be it. "Let the chips fall where they may" is their motto. "Don't let accounting conventions stand in the way of the truth."

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Our experience suggests that in a period of zero or even low inflation, values tend to decline. This is because of improvements in technology. Today's personal computer costs half as much and does twice as much as one made only three years ago. I just bought a microwave oven for $89. The same oven sold four years ago for $139. Examples could be carried out indefinitely.

When we get to productive machinery and equipment in the typical manufacturing environment, the same phenomenon holds true. But there are two countervailing forces at work in the business world.

Depreciation expense based on historical cost writes down the original cost to today's book value. But the accounting *life*, over which the asset(s) are depreciated, typically is way short of the real economic life of most assets. Thus, assets are depreciated too quickly. This is due, at least in the U.S., to trying to obtain the maximum tax expense possible. Many companies use the same life for taxes and books, hence the too-rapid depreciation. Put a different way, in the typical manufacturing environment there are many assets that are fully depreciated, still in use, and with a long life ahead of them. They are on the books with zero value but still have substantial fair value.

What we often find is that the current fair value of much machinery and equipment isn't all that different from book value. True, the replacement cost of a new asset has come down, but the asset has been depreciated too quickly. We are not arguing that two mistakes equal the right answer, but the solution for over-depreciation of machinery and equipment doesn't require going to fair value accounting.

As we have seen, current costs of replacement are typically dropping. Carried out uniformly, fair value accounting will likely show negative value changes from year to year.

Now put yourself in the position of a business executive. You report to your shareholders and creditors that you had a great year. Sales were up. Operating profits were up. But net income was down because of falling prices.

Which is the correct measure of performance? Economists and fair value proponents suggest that "real" income does encompass the decline in asset values. Most investors, however, are interested in evaluating management performance. In the real world, no company, no management, can control external economic events.

Put a different way, all companies in the same industry are subject to the same economic factors. The only important information to investors, and to management itself, is how well they did in buying and selling, manufacturing, and distributing products.

If the world goes to fair value accounting, we will make a flat statement: More often than not, operating performance for the year is going to be *overwhelmed* by changes in fair value. Lenders trying to evaluate security and equity analysts trying to evaluate growth prospects both will then have to "strip away" the impact of the changes in fair value in order to arrive at "real" company and management performance.

Now if we have to take out changes in fair value in order to understand what's really happening, the question immediately comes to mind, "Why do it in the first place?"

VALUES CAN BE DETERMINED ACCURATELY

I want to make one final point. Many who argue against fair value accounting state that we shouldn't adopt it because we can't accurately determine fair value. That argument is simply wrong. We, and other competent appraisers, can determine values accurately and with a degree of cost effectiveness. But someone has to specify, in advance, what *value* is needed. As we have seen, several different definitions of value are possible.

Our observation, based on years of experience, is that different users want different value information. There's no way that any one set of financial statements can be equally useful in all situations. If we put the emphasis on values defined in terms of *selling* the asset(s), i.e., liquidation values, that information will help lenders. It will be useless, however, to equity security owners who are anticipating the business continuing in use.

On the other hand, if we look at fair value as the cost to *replace* the assets today, i.e., to buy them at today's market price, this will overstate the value from the perspective of a lender but help the equity holder understand a measure of return on investment.

FAIR VALUE IS A FUZZY CONCEPT

The time for fair value accounting, if it ever has come, is now long gone. It doesn't provide better information for all users. It causes confusion. And, though outside the scope of this article, fair value accounting is at least subject to abuse. In the U.S. we have had several examples of such abuse, including the Enron and Qwest company disasters.

In order to disclose fair values, which can be determined accurately and objectively, it's necessary to specify just what information is needed. That task in itself is far from trivial and subject to as great disagreement as is the argument between proponents of historical cost accounting and fair value accounting.

The proponents of fair value accounting have not really thought through just what they mean by "fair value." Take it from someone who has spent his life trying to understand what fair value is and isn't. In reality, fair value is a very fuzzy concept! Why go from the precision of historical cost to the imprecision of fair value? Who wants it? Who needs it? ■

Alfred M. King, CMA, CFM, is vice chairman of one of the largest independent appraisal and valuation companies in the U.S. He has more than 34 years' experience in the field. His opposition to fair value accounting is based on that experience, even though adoption of such an accounting model would dramatically increase the volume of his firm's business. He can be reached at (609) 243-7013 or alfredking@erols.com.