

# Determining Fair Value

*The very essence of valuation  
is the professional judgment  
of the appraiser,  
not just a set of rules.*

**By Alfred M. King, CMA, CFM**

**F**air value financial reporting is being blamed for the subprime meltdown, bank failures, the credit crunch, and the current recession. Global warming is about the only thing not being blamed on fair value (FV) and mark-to-market (MTM) accounting. Before we're through, however, MTM will probably be blamed for global warming, obesity, and the collapse of Detroit's Big 3 domestic automakers.

Rarely have technical accounting, valuation, and financial reporting issues received so much attention from politicians, think tank specialists, columnists, and even TV journalists. Combined, these voices have raised the temperature of the discussion while shedding very little light on the issues.

It should be no surprise that the public—unhappy with market turmoil, bailouts, tight money, and a plunging stock market—is ready to point the finger at any and all participants within the business sector. Since it's easy to blame MTM if you don't really understand it, cries for a mandatory “change” in accounting rules are receiving a surprising amount of traction.

The following quote from a November 13, 2008, letter written by the American Bankers Association (ABA) to the Financial Accounting Standards Board (FASB) puts the basic issue into perspective:

“Recording OTTI [other than temporary impairment] that is based on credit impairment is non-controversial in the banking industry—financial institutions fully understand and support the need to record such impairment. However, there has been and continues to be much controversy over recording losses that are based on the market's perception of value (fair value), which often results in recognizing losses that exceed credit losses or recording losses for instruments that have experienced no credit problems and are fully performing in accordance with their terms. [emphasis added] The erosion of earnings and capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.”

## What Is Mark-to-Market Accounting?

For many years companies were able to show on their balance sheet the cost of securities they owned. U.S. Generally Accepted Accounting Principles (GAAP) seemingly said you should never anticipate gains (writing assets up) until they are realized. Meanwhile, losses should be recognized as soon as possible. This appeared to be a one-way street: “Good news” (gains) was hidden from creditors

and shareholders, but “bad news” (losses) was recognized. The rule about taking losses “immediately” really meant that write-downs had to be taken only when a decline in market value of securities was considered “other than temporary.” Since it was hard to define a “temporary” decline in market price, many companies chose to retain the original cost value on the balance sheet. They would disclose as supplementary information the current market price(s) of the traded securities they owned. This way, shareholders and creditors could get a picture of the “real” economics of the business.

Further, by showing original cost on the balance sheet and current market values in the footnotes or in parentheses, the company avoided reporting gains and losses from changes in the market price of securities unless, and until, they were actually sold. Companies were happy with this approach, and there were few complaints from financial analysts because it was easy to adjust the balance sheet for those who wanted to make that effort.

But a few journalists, academics, and analysts complained that this approach permitted companies to “cherry-pick” gains and losses. By selling stock with a built-in profit, the company would report an increase in income and earnings per share (EPS). If there had been some windfall and the company wanted to offset the gain, they could always sell securities that traded below the actual cost. This combination of choosing when to recognize gains and losses was referred to as “earnings management” and was criticized severely.

At the same time this debate was going on, the policy makers at the FASB were making a revolutionary change in financial reporting. Many members of the Institute of Management Accountants (IMA®) will remember that the original mantra of accounting was to “match” revenues and expenses. This was the gold standard for those who studied accounting as an undergraduate more than 10 or 15 years ago. The balance sheet was of secondary importance in that environment. In many respects, the balance sheet was a residual for carrying expenditures as assets prior to their being matched up with the appropriate revenues. The ultimate manifestation of the matching concept was deferred taxes, the balance of which was very difficult to understand or explain.

So the FASB, in its Conceptual Framework project, came to the belief that matching *per se* wasn't important. It's far better, the Board stated, to emphasize the balance sheet. Get the balance sheet right, and income for the year would be the difference between opening and closing net worth or equity. This new Conceptual Framework has

gradually been put in place with each new Standard the FASB has issued.

Starting with Statement of Financial Accounting Standards (SFAS) No. 107, “Disclosures about Fair Value of Financial Statements,” and SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” and concluding with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” the Board has mandated that almost all financial instruments should be valued at fair value and that *changes* in the market value of securities whose prices are marked to market should be reflected in the profit and loss (P&L) statement or equity section of the balance sheet. Therefore, changes in market value must now be reported directly.

Then some two years ago the Board issued SFAS No. 157, “Fair Value Measurements.” This new Standard, contrary to popular opinion, does *not* require further or additional use of fair value in financial reporting. What it *does* do is mandate that whenever fair value is required, it must be performed in accordance with the *definition* of fair value now embodied in GAAP.

## A New Definition and Unintended Consequences

For almost 120 years, the business community has had a single definition of fair market value (FMV), and this must not be confused with the FASB’s new definition of fair value. For reference, the standard definition of FMV is:

**“Fair Market Value is defined as the price for which property would exchange between a willing buyer and a willing seller, each having reasonable knowledge of all relevant facts, neither under compulsion to buy or sell, and with equity to both.”**

This seems pretty straightforward, and it is, because the definition really has only a few key requirements:

- ◆ An “exchange” of property, usually an asset, derived through negotiation;
- ◆ Willing buyer(s);
- ◆ Willing seller(s);
- ◆ Equal knowledge on both parts;
- ◆ No compulsion;
- ◆ Equity to both.

Now let’s look at the definition of FV as incorporated by the FASB in SFAS No. 157:

**“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.” SFAS No. 157 ¶ 5**

The key concepts of fair value as defined by the FASB are, put simply:

- ◆ Sale [not exchange],
- ◆ Market participants [sale to an unknown “market participant”],
- ◆ Orderly transaction,
- ◆ Definition applies to liabilities as well as assets.

The difference between these two definitions can best be understood in the concept of an art auction.

**Suppose there’s an auction of a Picasso painting at Sotheby’s or Christie’s. The auctioneer starts the bidding at \$20 million, and four rounds of bidding later the highest bid is \$29 million. All of a sudden, out of the blue, someone bids \$30 million, and there are no further bids. The auctioneer hammers down his gavel, and there is now a lucky buyer of the Picasso who is committed to pay \$30 million, disregarding taxes and commissions.**

What’s the fair market value of the Picasso? What’s the fair value of the same painting? One clue: The two answers are *not* the same!

Under the FMV definition given above, the value is considered to be \$30 million. There was an exchange of \$30 million between a willing buyer (nobody held a gun to the head of the last buyer) and a willing seller who obviously had placed the painting on consignment in the first place. We presume both buyer and seller are knowledgeable about Picasso’s art and current selling prices for comparable paintings. Finally, there appears to be equity for both since each participated willingly in the transaction.

Surprising as it may seem, under the FASB definition of fair value the painting is worth only \$29 million, not \$30 million. At least as seen from the perspective of the FASB, the new buyer immediately suffers a \$1 million impairment loss! How can this happen? Very easily, if you follow the Board’s logic in the SFAS No. 157 definition of FV.

Test the auction results against the FASB’s definition, and you’ll find that their concept of value is premised solely on an immediate sale to another “market participant.” Assuming every potential buyer of the Picasso throughout the world had attended the auction, we know for sure that there’s at least one prospective buyer (a “market participant”) at \$29 million. Further, we know that there are no other market participants at \$30 million, other than the lucky winner of the bidding war. This is true, or the bidding would have continued.

While counterintuitive, the instant impairment loss flows directly from the SFAS No. 157 definition of fair value, not from marking the painting to market. Under

the fair market value definition of value, we have \$30 million, which is what was paid on a willing basis. Under the fair value definition of value, we have \$29 million, which is less than was paid on a willing basis.

It's very clear: If you change the *definition* of fair value, you change the amount determined as the fair value.

## Banks vs. Fair Value and Mark to Market

It's well beyond the scope of this article to summarize the financial meltdown that began with subprime mortgages being issued to borrowers and the subsequent paper used as collateral for financial instruments sold by the issuers. The responsibility of the credit rating firms for granting the highest possible ratings to pools of mortgages that themselves were subprime is hard to understand, much less explain. The desire of investors for extra yield, plus a lack of understanding of the risks assumed by investing in those securities, certainly compounded the situation.

At some point within the past 18 months, many financial institutions, including Bear Stearns, Lehman Brothers, and Merrill Lynch, found that they held on their books enormous quantities of securities. These securities, while rated AAA by Moody's and Standard & Poor's, started to show serious default rates as individual borrowers were either unwilling or unable to keep up to date on monthly mortgage payments. The losses cascaded through the system very quickly, and, in a manner similar to a game of musical chairs, the final holders of what have been called "toxic securities" started to feel real pain.

Under GAAP this "pain" then became a trigger that caused auditors, as well as corporate management, to test the carrying values of the securities for potential impairment. Remember, trading securities have to be marked to market every financial period, but securities that are being held to maturity must be written down to market only if the current market price decline "is other than temporary." The prices for subprime financial instruments were continuing to tumble lower, and it was difficult (if not impossible) for anyone to argue, "This current decline is just temporary. Let's see if the housing market improves and borrowers resume making payments (instead of walking away from the homes). Then our securities will bounce right back!"

As prices for subprime paper kept going lower, two things were happening. Companies were reporting losses due to the decline in market value. The losses in turn reduced the capital cushion that firms have to have on hand because every dollar of loss reduced net worth

directly. Declining net worth *had* to be rebuilt. If a company has zero net worth, this is one of the tests for bankruptcy; as net worth kept declining, there was tremendous pressure on the holders of these now almost unsalable securities (that is, unsalable at a "reasonable" price) to obtain new capital.

One way to shore up the balance sheet was to convert securities into cash. The only way to accomplish this is to sell the securities to someone else—someone who can and will pay you. All of a sudden there were more sellers than buyers *at the price levels that sellers hoped for*.

## Forced or liquidating sales do not represent fair market value and, according to the FASB and SEC, really don't reflect fair value either.

Economics 101 says that when there are more potential sellers than buyers, the only way for the market "to clear" is for prices to go down to a level at which buyers will respond. In the last half of 2007 and all of 2008, securities markets in the United States once again proved that the Law of Supply and Demand was alive and well. In short, the basic tenet of Economics 101 had NOT been repealed.

Many of those adversely affected by the events of the past year and a half are pleading for a major change in accounting. A "simple" change to GAAP, they assert, would have precluded the prior problems and would allow future recovery to go much faster. All that Congress, the Securities & Exchange Commission (SEC), or the FASB would have to do is repeal SFAS No. 157 dealing with fair value. According to these market participants, including the American Bankers Association, it was marking securities to fair value that caused the problem!

## How Repealing Fair Value Would "Solve" the Problem

Many bankers have chosen to make the argument that it was the FASB's mark-to-market requirement that caused much of the problem, not necessarily that their prior investments in subprime mortgage-backed securities and

credit default swaps were poorly thought out.

Their theory is that if fair value were repealed, then mark to market would be easier to meet because the “market” would now be something much higher. There had been a “death spiral” as reported sales prices drove prices lower, which forced more sales and so on. Repealing fair value would make MTM *look* a lot better, and there wouldn’t have to be forced sales because capital wouldn’t be eroded. With sufficient capital potential not being wiped out, lenders to Wall Street would once again jump on board, and all would be right with the world. And the only thing that’s required is a temporary suspension of SFAS No. 157!

If only things were that simple.

There’s no question that prices for subprime securities were in a death spiral. The lower prices caused still more sales, and the more sales caused still lower prices. That’s incontrovertible.

But blaming this all on mark-to-market requirements misses the point. Critics of abolishing SFAS No. 157—those in effect supporting the present system—argue that not disclosing current prices is like breaking a thermometer if you think the temperature is too hot. It’s the heat, not the thermometer, that causes discomfort. Similarly, it was low prices for subprime securities that caused the financial discomfort, not marking them to market.

The argument that *knowing* the “truth” is better than disguising things simply to look better is hard to contradict. Marking security prices to market makes sense, but if—and only if—the “market” is accurate.

## What’s the *Real* Market?

If there’s a good market price, and if you have assets that are not only readily available for sale but are likely to be sold, then disclosing the current market prices should be mandatory.

There are two separate concepts incorporated into the above sentence, and each is important:

- ◆ There’s a functioning market with willing buyers and sellers not under compulsion.
- ◆ There are assets that could and would be sold into that market.

Look at the two requirements. Taken separately, each is necessary but not sufficient to support MTM accounting.

**Requirement No. 1.** There has to be a functioning market for the quoted prices to reflect real value. The problem over the past six months is that many of the reported sales were *forced* or *liquidating*. **Forced or liquidating sales do *not* represent fair market value and,**

**according to the FASB and SEC, really don’t reflect fair value either.** The trouble is that when Merrill Lynch sold some \$30 billion (face value) of securities at 22 cents on the dollar, some observers believed that was a market price in accordance with the definition of SFAS No. 157. The problem is that the FASB’s use of the term “orderly transaction” appears to be misinterpreted by many companies.

The term “willing seller” in the FMV definition would be a lot easier to interpret. There is little doubt that Merrill Lynch was an *unwilling* seller because it was being forced to sell securities, almost irrespective of price, in order to improve its capital position. The business press, in fact, commented at the time that they were lucky to obtain any bid because the real question was how the buyer (a hedge fund) was ultimately going to make out. The Merrill Lynch transaction was “orderly” in the sense that the buyer paid the seller. But the whole thrust of the FASB definition on “exit value” meant that it was easy to interpret the 22 cents on the dollar as Merrill’s “exit price.” In effect, this is the argument the ABA made in another part of the letter from which I quoted earlier.

The ABA argument really faults the major accounting firms for trying to apply “rules” regarding the fair value of a particular security and determining by that rule when an impairment exists and must be recorded. Yet there are no formal rules in GAAP as to the determination of “the market.” The real determination of fair value or fair market value involves judgment.

The need for judgment is the reason that we’ll never arrive at full fair value accounting. Liquidation values differ from going-concern values. Who will tell a company what assumption to make, whether FV should be determined on liquidation or going-concern assumptions? And who will determine whether a particular transaction by a third party, as reported in the press, was or was not a forced sale? Forced or liquidating sales don’t represent the “market.” Yet without specifying the assumption, how could you compare Company A, which values everything at going concern, with Company B in the same industry, which values everything at liquidation value?

Both values can fulfill the SFAS No. 157 definition of fair value, depending on your assumption of which “market participant” would be the buyer.

**Requirement No. 2.** Determining the fair value of assets that *won’t* be sold appears to provide little useful information to investors and creditors. The overriding purpose of financial reporting, according to the FASB’s own Conceptual Framework, is to provide information

about future cash flows.

If there won't be future cash flows because management has determined that the assets aren't for sale, how does provision of FV information aid in investor decision making? You can argue that management perhaps *should* be willing to sell any and all assets, but we haven't reached the point where creditors and shareholders actually run the company. In fact, the only time that creditors *do* get to make such decisions is after the company has filed for bankruptcy.

To assert that financial reporting should be based on a bankruptcy model that everything is for sale would surely destroy the real underlying value of any going concern. There's a vast difference between valuing assets for the purpose for which they were acquired and valuing them as though they would or could be liquidated.

## The Role of Professional Judgment in Valuation

As I said earlier, blaming mark-to-market accounting for the financial reporting problems of financial institutions misses the point. The real issue is in trying to make the FASB's definition of fair value, which focuses on sales to "market participants," provide useful and valid data. The FASB definition of fair value is flawed, as discussed above. The single-minded application of auditors in interpreting any recent transaction as automatically representative of fair value simply adds to the problem.

In effect, the FASB and auditors implicitly assume that fair value is a single objective amount that, with sufficient effort, can (1) be determined by management, (2) reviewed by auditors, and (3) disclosed to investors and creditors. It's this flawed assumption that lies at the heart of the untold discussions among the participants in the financial reporting world.

The fact is that the "value" of any asset is *never* a precise figure. Values can be determined objectively and without bias, but only within a **range**. This range may be plus or minus 10% of the midpoint. Accountants can't work with ranges; they need a single dollar amount that can be processed through journal entries to the financial statements.

But there are no black boxes for valuation where you input variables and an answer pops out. The very essence of valuation is the professional judgment of the appraiser. Different appraisers will arrive at somewhat different indications of value. Ordinarily, if two appraisers are given the same assignment and the same basic assumptions (liquidation value or value in-use), they will usually be

within the 10% plus or minus mentioned above.

Unfortunately, when it was drafting SFAS No. 157, the FASB chose not to heed the advice of professional appraisers. We warned the Board and the staff that their definition was flawed and would cause problems. They "listened" but then chose to go their own way. That, of course, is their prerogative. They make the rules. But SFAS No. 157 is fundamentally flawed. The definition of fair value, now enshrined in GAAP, underlines the Board's lack of understanding about how appraisers actually do their work. The problems now facing the government, investors, and financial institutions have been wildly exacerbated by SFAS No. 157.

Again, the issue isn't mark-to-market accounting—it's the definition of fair value used to derive the so-called "market." Until SFAS No. 157 is changed and auditors are willing to accept the professional judgment of appraisers, the problems hitting the headlines will continue. We may not like it, but things will probably get worse before there can be true improvement. The FASB and auditing firms aren't noted for flexibility! **SF**

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