

The fair value debate: from accounting utopia to financial realism

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The aim of accounting is to reflect the financial position of a business as realistically as possible. Given the growing complexity of the economic world, the development and globalization of financial markets, and the expanding influence of the ideology of shareholder value, historical value accounting has become increasingly out of touch. To better align accounting with this new reality, accounting standard-setters have gradually replaced the historical cost principle with fair value. In the two key bodies of accounting standards (US GAAP and IFRS²), the concept of fair value has become more and more predominant³.

The merits of fair value have always prompted heated debate, particularly with regard to financial instruments. However, since the onset of the financial crisis, the controversy has intensified. It appears that the combination of the fair value principle and accounting-based capital adequacy rules for banks may have had a procyclical effect. Certain managers of banks and insurance firms have been falling over themselves to blame accounting standards⁴ for the current predicament, along with credit rating agencies and hedge funds. Obviously, though, it's much easier to criticize accounting standards than capital adequacy rules when you are under the watchful eye of banking supervisors.

Importantly, however, the fair value principle did not take a hammering from leaders at the G20 summit on November 15, 2008. The statement published after the summit made no reference to fair value, although accounting authorities were asked to “work to enhance guidance for valuation for securities, also taking into account the valuation of complex, illiquid products, especially during times of stress”.

Without going so far as to result in completely clear, workable solutions, one of the positive aspects of this crisis has been to shed light on the debate regarding two key issues that hail the end of a certain accounting utopia and the return to financial realism:

- Conceptually speaking, preparing a balance sheet that can or even must give a realistic view of a company's market value is too much to ask. The market is far too complex to be captured by an accounting system.

¹ The opinions expressed in this article are those of the author only, and do not necessarily reflect the positions adopted by Houlihan Lokey.

² International Financial Reporting Standards.

³ Fair value is mentioned 1,184 times in the European Commission's November 3, 2008 Regulation on International Accounting Standards.

⁴ For an excellent account of this debate, see Nicolas Véron, *Fair Value is the wrong scapegoat*, Bruegel, May 2008. Available on: http://veron.typepad.com/main/files/BruegelPolicyContribution_May08.pdf.

- The practice of valuation necessarily involves a large degree of subjectivity. Framing this process by a set of accounting rules is dangerous. The constraints imposed on valuation practitioners have thankfully and understandably been loosened up.

The limits of accounting

The infusion and subsequent injection of ever stronger doses of fair value into accounting literature have not resulted in a more realistic view of companies. Two major hurdles first have to be cleared: the limitations inherent to the very nature of accounting and the complexity of the economic reality it sets out to capture.

Financial and accounting information is aimed at helping investors make decisions. To this end, certain fundamental characteristics must be present. According to the conceptual framework of the IASB⁵, information must be relevant in order to be used to determine a company's financial position; it must be reliable, i.e. free from material error and bias; it should be comparable so that investors can identify trends in a company's financial position and performance and compare them with similar companies; and finally, it must be understandable for users. In theory, the introduction of fair value accounting makes financial statements more relevant. However, it is uncertain whether fair value has enhanced these other fundamental characteristics.

First and foremost, the notion of fair value is extremely subjective⁶, and is defined slightly differently by each body of standards. US standard SFAS⁷ 157 defines fair value as “the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date”. Fair value under SFAS 157 is therefore a theoretical exit or sale price. Under IAS⁸/IFRS, fair value is the result of an exchange, and is defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction”.

Under US standards, the fair value of liabilities is defined by reference to the notion of a transfer, whereas the definition provided by IAS/IFRS refers to the amount for which a liability can be settled between knowledgeable, willing parties in an arm's length transaction.

These differences are ultimately set to disappear. SFAS 157 was developed to provide a single definition of fair value and a coherent framework for pricing assets and liabilities under US GAAP. IFRS still have some way to go before they achieve this, as certain inconsistencies remain in the definitions provided by different standards. SFAS 157 is currently being used as a basis for drafting an IFRS standard providing a single definition of fair value and clear application guidance, scheduled for publication in 2010.

Besides these differences which risk impairing the international comparability of businesses reporting under different accounting standards, it is important to remember that this approach to valuation will always be subjective and theoretical. The definitions of fair value are based on those used by valuation practitioners to calculate “fair market value”, considered to be “the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts”⁹.

⁵ International Accounting Standards Board.

⁶The word “fair” also carries a moral connotation that seems out of line with the subject to which it relates.

⁷ Statements of Financial Accounting Standards.

⁸ International Accounting Standards.

⁹ This definition is consistent with the 1919 definition given by the Bureau of Internal Revenue in the US: “*the market value is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price*”.

Willing buyers and sellers are hypothetical parties to a transaction acting at arm's length. They must have the capacity to carry out the transaction (the market brings together all potential buyers with all potential sellers), and the transaction must take place under prevailing market conditions. Fair market value implies that the asset has been exposed to a market that has been operating for a sufficient period of time to bring together buyers and sellers so that a "value" can be determined at the end of the process.

At least three different notions have therefore been brought into play so far: value, price and fair value. From a valuation standpoint, value should be distinguished from price, as it reflects the opinion of a given investor regarding the estimated future return on an asset. There are as many opinions on the value of an asset as there are potential investors. Price, on the other hand, results from a comparison between different viewpoints on value. Price is a fact and not an opinion. Fair value, in contrast, is the theoretical price that a company could obtain if it decided to sell an asset or settle a liability under the conditions described above. Fair value is actually an opinion on a hypothetical fact, and referring to it as a market value does not make it any less theoretical!

The reliability of fair value therefore depends on the asset to be valued and the existence of a market on which it could theoretically be traded. Fair value is relatively easy to apply in the case of listed securities. But accounting regulations also require fair value accounting for assets and liabilities not listed on an active market or traded under rather opaque conditions, such as:

- complex financial instruments which have been structured to meet specific investor needs. These instruments are traded over-the-counter and only certain market makers (maybe) understand the related financial implications. As the recent crisis has proved, most of those who had a hand in structuring or selling these instruments were simply unable to put a price on them;
- intangible assets acquired by companies. In an acquisition, the acquirer has to allocate the purchase price between (i) the acquiree's property, plant and equipment and intangible assets, and (ii) its goodwill. Unlike tooling or inventories, most of these assets (customer base, brands, technologies) cannot be traded on a market;
- cash-generating units¹⁰ (CGUs) defined by companies. Under IAS 36, the recoverable amount of CGUs must be tested to ensure that it has not fallen below the carrying amount of the assets. The recoverable amount of an asset or cash-generating unit is "the higher of fair value less costs to sell and value in use".

This last example brings yet another notion to stand alongside value, price and fair value: value in use. Value in use can be considered to approximate value in the strict sense of the word, since it is defined as "the present value of future cash flows expected to be derived from an asset or cash-generating unit" as determined by management. However, the application of value in use recommended by the standards strays far from the methods actually used by valuation practitioners, particularly as regards defining the cash flows to be taken into account in the calculation¹¹, and consideration of the related risk and impacts of financing.

All fair values except those directly resulting from prices quoted on an active market must be calculated based on internal pricing models used by brokers, companies, or independent

¹⁰ A cash-generating unit is the "smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets."

¹¹ For more details about these differences, see Bruno Husson and Jean-Florent Rérolle, *Explanatory guide to IAS36* (Chapter 3), Cahiers de l'Académie n° 7, March 2007. Available on: http://www.focusifrs.com/content/download/2033/10039/version/1/file/Cahiers_Academie_07_0703.pdf

appraisers, who do indeed apply inputs from indirect markets (as seen below) but also largely rely to a great extent on their own judgment¹².

Although fair value now holds considerable sway in modern accounting systems, it is far from being the only expression of balance sheet value. Historical cost, current value and realizable value are still widely used in preparing financial statements and many assets are not recorded on the balance sheet. This results in “hybrid” balance sheets, where, for example:

- a significant portion of intangible assets are not reported: at the end of 2007, 44% of the market value of CAC 40¹³ companies was made up of intangibles not recognized on the balance sheet. Despite the collapse in equity prices, intangibles still accounted for 16.3% of market value in mid-December 2008;
- intangible assets are an essential part of corporate balance sheets: goodwill and identifiable intangible assets represented nearly 22% of the total assets of CAC 40 companies at the end of 2007. This percentage could rise to 36.6% before taking account of the provisions companies will be booking in their 2008 accounts¹⁴;
- the portion of assets carried at fair value as a percentage of total assets varies widely depending on the type of company (e.g., financial or non-financial) and the accounting choices made by the company¹⁵;
- methods for calculating fair value are also extremely diverse. They may have been implemented by the company itself with the risk of being biased, or by an independent expert who can offer more objectivity;
- corporate liabilities are shown at the amount at which they are first recorded in the financial statements, unless the company has become part of a consolidated group. For financial institutions, marking assets to market and recognizing certain liabilities at historical cost introduces a mismatch which impairs transparency and the risk management process;
- depreciation, amortization and impairment charges are sometimes recognized arbitrarily by companies, and are not necessarily related to the market value of the underlying assets;
- assets or cash-generating units¹⁶ (CGUs) may be valued without taking account of potential or actual synergies between them. This segmented, partial approach is the exact opposite of financial market rationale, which sets out to build all such factors into its valuations;
- companies that have grown organically have not been capable of externalizing the intangible assets they have developed;
- impairment losses charged against goodwill cannot be reversed, unlike those charged against financial assets.

¹² The IASB moreover recognizes the subjective component of these calculations in its report, *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* (IASB, October 2008): “As a result of applying judgment, two entities might arrive at different estimates of the fair value of the same instrument even though both still meet the objective of fair value”.

¹³ By market value, we mean enterprise value (market capitalization + net debt).

¹⁴ At December 16, 2008, property, plant and equipment represented 47.1% of the market value of CAC 40 companies, identifiable intangible assets 11.9%, goodwill 24.7% and unrecognized intangible assets 16.3%.

¹⁵ See P.Artus, J-P Betbèze, C. de Boissieu and G. Capelle-Blancard, *La crise des subprime* (page 187), La Documentation Française 2008.

¹⁶ CGUs may be broken down so as to pool certain profits and losses, thereby avoiding the recognition of any impairment loss.

Lastly, it should be noted that the constraints under which financial information is prepared do not make that information particularly usable for investors. Admittedly, publication deadlines have been considerably shortened, but they are still not short enough for markets that react every day and even every moment to available information published by companies or by other sources. By the time accounting data is finally published, it has already been largely factored into the share price¹⁷. And given the increasing volumes of accounting data published, it probably takes longer than ever to digest!

The very nature of accounting information and the constraints under which it is prepared therefore stand in the way of its aim to give a true and fair view of a company's financial position. At most, it can offer reliable information about a past situation (and past expectations for the future). But its usefulness for immediate decision-making is limited.

There is, however, another more formidable obstacle to overcome: the complexity of the forces at work in the economy at large and on financial markets in particular, a complexity which does not readily allow itself to be hemmed in by standards, regulations or predefined rules.

An overreaching ambition

By placing value at the core of its thinking, the accounting standard-setter assumes that market information flows effectively and results in a share price that is a faithful reflection of a company's fundamental performance¹⁸. However, each economic crisis casts serious doubt on this association.

As Christian Noyer, recently put it, "in many respects, the current crisis is about valuation"¹⁹. This crisis of value stems from the increasing complexity of value creation mechanisms, the iterative dynamic between market value and fundamental value, and lastly the widening gap between our intellectual models and the new value paradigm.

A company's fundamental value depends partly on the return on its existing assets, and partly on the growth opportunities it may hope to leverage in the future thanks to its positioning or strategy. To create value, a company must create and maintain decisive, lasting and defensible competitive advantages, which allow it to generate an economic return on its assets in excess of its cost of capital.

In a global, dematerialized economy organized in business webs, competitive advantages can be difficult to recognize²⁰, as the borders of companies shift and/or become porous. The economic benefits or costs of an (often temporary) alliance or agreement with a business partner or even a competitor cannot easily be clearly identified. Uncertainty as to the origin and beneficiaries of future cash flows is compounded by the intangible nature of the asset base and of the offer²¹.

On top of these characteristics – typical of what used to be known as the "New Economy" – there is now uncertainty as to future trends in commodity prices and the long-term survival of

¹⁷ Particularly because stock market regulations require companies to disclose to the market any information likely to affect their share price, especially changes in performance or their financial position.

¹⁸ See Christian Walter and Eric Brian, *Critique de la valeur fondamentale*, Springer 2007.

¹⁹ See Christian Noyer's speech in *Lessons from the crisis: A central banker's reflections on some accounting policy issues*, European meeting of the accounting profession, December 11, 2008. Available on: <http://www.bis.org/review/r081218a.pdf>.

²⁰ See Jean-Florent Rérolle, *Value creation in the connected economy*, *Analyse financière*, September 1998.

Available on:

[http://www.rerolle.eu/public/1998f Value Creation in the Connected Economy Traduction Analyse financiere oct 1998.pdf](http://www.rerolle.eu/public/1998f%20Value%20Creation%20in%20the%20Connected%20Economy%20Traduction%20Analyse%20financiere%20oct%201998.pdf).

²¹ See Stan Davis and Christopher Meyer, *Blur: The Speed of Change in the Connected Economy*, Addison-Wesley, 1998

business partners and subcontractors. This has forced most companies to completely revisit their business models in a context where globalization and information technologies have spawned a host of new competitors. The change in the competitive landscape increases opportunities for future growth and for competitive advantages, but also heightens uncertainty as to the occurrence, impact and duration of these opportunities. Uncertainty creates systematic, specific and systemic risks that now play an essential role in investors' assessments of a company's ability to create value. This seismic shift can justifiably be referred to as a new value paradigm.

The second factor behind the crisis is the iterative dynamic existing between market value and fundamental value. Obviously, in an ideal world where information flows effectively throughout the market, a company's share price would be perfectly in line with its fundamental value. This is far from being the case, for a number of reasons:

- share prices are the result of a complex anticipation process that may be temporarily out of step with management's estimates. Share prices are the expression of every scenario envisaged by investors, weighted by the likelihood of their occurrence. This depends on the strategic alternatives and system of corporate governance put in place by the company. Share price fluctuations reflect the volatility of the company's current and potential competitive positions in an economy where the hazard becomes "wild"²²;
- share prices are also influenced by market psychology. Faced with uncertainty, investors can develop a mimetic pattern of behavior which drives them to look more at what other investors are doing rather than at the reality of the company itself. After all, who wants to be the only one in the right? This imitative tendency – with regard to either information or inherent patterns of behavior – is in fact perfectly rational!
- the environment in which an investor acts is also critically important. Current volatility in the market is perfectly illustrated by the "Millennium Bridge" syndrome. This occurred when the bridge began to wobble under the feet of thousands of pedestrians who had gathered to witness its inauguration in 2000. Naturally, the pedestrians adjusted their stance to regain their balance, but they all did so at the same time, which made the structure wobble even more. The analogy with financial markets is clear: an asset's price reflects underlying economic fundamentals, but is also an "imperative to action"²³;
- there is a feedback loop between market value and fundamental value. A company's future growth opportunities are an important part of its market value. Growth opportunities are honed by management, and financially approved by investors when built into price expectations. However, these expectations can be wiped out by tumbling share prices: by limiting the company's ability to finance its future growth opportunities, investors themselves reduce its value. This situation can obviously degenerate, locking market value and fundamental value together in a downward spiral;
- lastly, in certain situations such as the current crisis, market value no longer reflects investors' expectations of risk and return, but the amount of cash available to potential buyers in the market²⁴. This has a profoundly unsettling effect, setting off a chain of reactions whose scale or implications cannot yet be measured.

The third factor to have emerged from the crisis is the obvious gap between intellectual valuation models and the new value paradigm. The very foundations of these models must be revisited to

²² Expression coined by Benoît Mandelbrot.

²³ Plantin, Sapra, Shin, *Fair value accounting and financial stability*, Financial Stability Review, October 2008. (<http://www.ecb.int/pub/pdf/scpops/ecbocp13.pdf>)

²⁴ Allen and Carletti, *Mark-to-market accounting and liquidity pricing*, Journal of Accounting and Economics, 2008. Available on: <http://finance.wharton.upenn.edu/~allenf/download/Vita/Allen-Carletti-MMA-200706-final.pdf>

better comprehend the “economy of extremes”²⁵. Traditional models such as CAPM, Black-Scholes and VaR are based on an assumption of normality whereby 95% of risks occur within an interval of two standard deviations. This assumption considerably simplifies risk measurement.

However, since the early 1960s share price fluctuations have been known not to follow a Gaussian distribution: minor fluctuations occur more frequently than expected, average fluctuations occur less, and distribution tails are fatter. A handful of changes accounts for the bulk of a company’s share price performance: for example, if we exclude the 10 worst daily performances of the Alcatel share over the past year (representing 4% of prices observed), the annual return on the share would have been +10.2% rather than -70.2%! The extreme volatility of equity prices over the past few months is a further illustration of the need for a new approach to risk treatment in financial valuations.

From this standpoint, fair value’s new preeminence in accounting has done more to inhibit valuation than to revamp it. Obviously, an economic view of accounting is preferable to a purely historical one. But it is dangerous and illusory to set valuation approaches in stone, since some already tend to be out of step with conventional financial logic²⁶.

The recent crisis has uncovered difficulties in valuing certain financial assets which had nevertheless been developed using sophisticated financial models. The same difficulties emerged when pricing more conventional ‘real’ assets. The diversity of business models and the complexity of the interactions between the real economy and financial markets mean that no single approach to valuation can hold true at all times and in all places.

Rigid standards

Aware of the potential difficulties in using fair value as the market price for certain assets, regulators have established a fair value hierarchy. The replication of market price depends on the information that is available about this price. US GAAP and IFRS have therefore ranked sources of fair value based on the inputs used in the calculation and the type of assets concerned.

The five levels identified in IAS 39 for determining the fair value of financial assets should soon converge with the three-level structure used by SFAS 157:

- Level 1 inputs are prices on an active, organized market for assets or liabilities identical to those being valued, which the company has access to at the measurement date. This is considered the most reliable approach by regulators.
- Level 2 inputs are directly or indirectly observable market data (other than prices listed on an active market) for the asset or liability. These include prices for similar assets or liabilities on an active or inactive market, and financial data that may be used in pricing the asset (interest rates, volatility, credit rating, default rate, multiples, etc.). These data can be adjusted to a certain extent in order to be applied to the asset or liability to be valued. All material adjustments would lead to the inputs being classified as level 3.
- Level 3 inputs are unobservable data. However, the same objective remains: fair value must be the hypothetical price the asset would fetch on the market. Level 3 inputs must reflect the assumptions made by the company’s management about the assumptions that market participants would use to price the asset or liability.

²⁵ Daniel Zajdenweber, *Economie des extrêmes*, Flammarion 2001.

²⁶ See Idier, Jardet, Le Fol, Monfort, Pegoraro, *Taking into account extreme events in European option pricing*, Financial Stability Review, October 2008
http://www.banque-france.fr/gb/publications/telechar/rsf/2008/rsf_1008.pdf

The first category in the above hierarchy is known as “mark-to-market”, while the other two are known as “mark-to-model”.

IFRS applies a different approach for non-financial assets, with IAS 36 identifying three different sources of fair value:

- the price in a binding sale agreement;
- if there is no binding sale agreement, the asset’s market price less the costs of disposal;
- if there is no binding sale agreement or active market, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at the balance sheet date, from the disposal of the asset in an arm’s length transaction between knowledgeable, willing parties, after deducting the costs of disposal. The standard specifies that, on determining this amount, an entity must take into consideration the prices of recent transactions for similar assets within the same industry.

Despite their implacable logic, these definitions cause formidable difficulties for practitioners seeking to determine a value that most closely reflects financial reality.

The use of level 1 inputs implies that the market for the asset is sufficiently deep and liquid. Even in normal circumstances, it is unclear whether sales of large blocks of shares could be carried out on an organized market risk without destabilizing the share price. Furthermore, as illustrated above, market prices reflect both a company’s fundamentals and the impact of the financial environment and investor behavior. Valuation professionals should therefore never apply a listed market price without having first considered whether it is a genuine reflection of the asset or liability’s economic fundamentals.

When the relevant markets are not organized, implicit share price assumptions or indications given by brokers should be analyzed in depth to determine the extent to which the input can be used and/or needs to be adjusted. Any adjustments made risk classifying the input as level 2 (observable market data).

Given these difficulties, valuation practitioners frequently use a mark-to-model approach, feeding the model with as much market data as possible. However, since the results are highly sensitive to the inputs used, there is always a risk that the data may be manipulated. Admittedly, when models are not set up by independent practitioners, they risk being strongly biased, which then affects fair value, irrespective of whether or not there was an intention to manipulate figures at the outset.

For non-financial assets measured at fair value, a listed cash-generating unit is found only rarely. Most often, companies will have to use the third alternative, which seems to favor a method based on comparisons with similar companies. This comparables method is widely used in practice since it is considered the easiest to apply. However, it does have some important hidden flaws and its use is in actual fact extremely complex²⁷.

Many practitioners were reluctant to use discounted cash flow methods as these seemed redundant or in contradiction with the method described for calculating value in use. However in practice, many companies use this approach which is consistent with traditional financial thinking. Indeed, the value of an asset is generally agreed to be equal to the sum of its future cash flows, discounted at a rate that reflects investors’ required return (itself indicative of the asset’s systematic risk).

²⁷ See Jean-Florent Rérolle, *Les multiples: méthode d’évaluation ou de décryptage ?*, Les Echos, November 17, 2005. Available on: <http://www.rerolle.eu/category/Publications>.

Besides being apparently in contradiction with current standards²⁸, the discounted cash flow method is particularly difficult to apply because cash flows should be determined on the basis of “market participants” assumptions. If management assumptions such as business plans are used in the calculation, they should be corroborated by observable market data such as analysts’ forecasts or industry studies. Practitioners added that “if no evidence is available to ensure that the market assumptions applied are reasonable, fair value less costs to sell cannot be reliably estimated and the recoverable amount can therefore only represent value in use, as determined under the conditions set out in IAS 36”²⁹.

In practice, this mark-to-model valuation using as many market assumptions as possible is relatively unrealistic. Brokers’ reports do not generally demonstrate a satisfactory level of granularity in terms of either financial forecasts or business segmentation. Even when they exist, analysts’ views have to be shown to be representative of views held by “market participants”. This is however doubtful, not only because of the difference that usually exists between market prices and analysts’ expectations, but also because cognitive studies show that in hypothetical situations where there is a large degree of freedom (such as in financial markets or the economy), the group is a more accurate forecaster than an expert³⁰.

So even in normal market conditions, the application of fair value is not a given, regardless of whether a mark-to-market or mark-to-model approach is used. Despite the practical and even logical difficulties of incorporating as many market assumptions as possible into the process, regulators and auditors have often proved to be extremely demanding of companies.

Signs of increasing flexibility

This position has proved to be difficult to defend in the current circumstances and since last September, a number of policy statements and official recommendations have injected a certain degree of interpretive flexibility into rigid accounting standards in a bid to take account of the evolving financial climate.

The EESA³¹ Act of October 3, 2008 granted the SEC the authority to suspend the application of SFAS 157 for all companies and all asset classes. The SEC chose not to suspend SFAS 157, but instead issued a joint statement with the FASB on September 30, 2008 followed by an amendment to SFAS 157³² on October 10 regarding the calculation of the fair value of a financial asset for which there is no longer an active market.

On October 12, 2008, leaders at the euro zone summit recommended adopting a coordinated approach to ensure “sufficient flexibility in the implementation of accounting rules”. They added that companies and financial institutions should be allowed to value their assets “consistently with risk of default assumptions rather than immediate market value which, in illiquid markets may no longer be appropriate”.

On October 13, 2008, the IASB issued amendments to IAS 39 to permit reclassification of some interest rate derivatives out of the fair-value-through-profit-or-loss category and available-for-sale

²⁸ The rule is going to change, as we will see later on in this article.

²⁹ See ASTCF, *Dépréciation d’actifs, précision sur la juste valeur diminuée des coûts des ventes*: Cahiers de l’Académie, March 2007.

³⁰ See M. Mauboussin, *More than you know (Chapter 6: Are you an expert? Experts and markets)*, Columbia Business School Publishing 2008.

³¹ Emergency Economic Stabilization Act.

³² See FASB Staff position, SP FASB157-d.

category and into “banking” categories measured at amortized cost. This option was already available under exceptional circumstances to US institutions³³.

On October 2, 3 and 14, the IASB published a series of statements indicating that the positions taken by the US regulator were consistent with IAS 39. These statements were supplemented by a report issued by the IASB Expert Advisory Panel entitled “Measuring and disclosing the fair value of financial instruments in markets that are no longer active”, and comments from IASB staff.

All of the panel’s recommendations can be summed up in a few common sense principles:

- the objective of a fair value measurement is to determine the price at which an orderly transaction would take place. However, a forced sale cannot be considered as an orderly transaction, since market participants are not willing parties and the market is unable to price the assets involved. Accordingly, it cannot be used as a basis for measuring fair value;
- all observable market inputs should be taken into consideration. When measuring fair value using a valuation technique, an entity should maximize the use of relevant observable inputs and minimize the use of unobservable inputs;
- if the market for the asset is not active, transaction prices can be used as an input in the fair value calculation, but cannot alone determine fair value. Transaction prices might also need to be significantly adjusted;
- care must be taken in determining whether a market is active or inactive. Characteristics of an inactive market include a significant decline in the volume and level of trading activity, significant price fluctuations over time, and non-current prices. An active market is one in which transactions are taking place regularly on an arm’s length basis. Once again, the meaning of “regularly” is a matter of judgment;
- when relevant observable market data does not exist or cannot be used, fair values are determined using a valuation technique based primarily on management’s internal assumptions about future cash flows and appropriately risk-adjusted discount rates. Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make, such as for credit, liquidity and models;
- however, in some cases, the regulators acknowledge that “using unobservable inputs might be more appropriate than using observable inputs”³⁴(!), particularly when significant adjustments have to be made to observable inputs;
- prices obtained from brokers should be used with caution, because when markets are not active, these intermediaries are likely to rely more on models than on actual transactions, with inputs based on information available only to the broker or pricing service.

These amendments concern only financial assets. Proof that views are beginning to change, the rules concerning non-financial assets are also evolving in an attempt to provide a more accurate financial picture. In May 2008, the IASB published a proposed amendment to IAS 36 which basically allows fair value less costs to sell to be calculated using a discounted cash flow method.

Lastly, the regulator’s insistence on the need to improve transparency about fair value will probably contribute most to reviving a debate whose force is somewhat exaggerated, at least

³³ See on this subject Laurent Flallo’s comments in *Petits arrangements entre amis avec la comptabilité*, Les Echos, November 12, 2008.

³⁴ See IASB Staff Summary, *Using judgement to measure the fair value of financial instruments when markets are no longer active*, IASB, October 2008. Available on http://www.iasb.org/NR/rdonlyres/F3AFDA4D-6605-42CE-858F-23BBB9044355/0/IASB_Staff_Summary_October_2008.pdf

from the standpoint of financial market theory. Investors are constantly adjusting all available information to their needs. It is of little importance that this information is processed upfront by the company and enshrined by accounting regulations. Markets need transparency more than they do standards.

Investors are under no illusions about the reliability of the fair values published by companies. As they too use the valuation process, they are aware of the degree of subjectivity involved. When a company values its assets, it is making a judgment about a large number of inputs. The value obtained is merely an opinion – admittedly better informed than most would make – but an opinion which remains brittle and is likely to be refuted at some point in the future.

The real problem for investors is the difference between the information available to them compared with that available to company management. From this perspective, mark-to-model approaches for which accounting standards require an additional layer of transparency³⁵, are actually more useful to investors than a published price which they already know, and which is probably several months out of date.

As a result, companies using discounted cash flow methodologies must:

- disclose each key assumption to which fair value is most sensitive;
- describe the approach used by management to determine the amounts assigned to the key assumptions and their consistency with the past, and where appropriate, with external sources of information;
- justify the forecast period chosen;
- indicate the perpetual growth rate used to calculate terminal value and if the rate exceeds the long-term growth rate applicable to the product, industry or country, give a reason for this;
- disclose the discount rate(s) used in the forecasts.

If correctly presented in the notes to the financial statements – which form an integral part of such financial statements – this information (more than the value obtained) provides investors and analysts with a precious indication of management's expectations. The information also reveals the sophistication of management with regard to shareholder expectations, and can therefore inspire either a trusting or cautious attitude.

These disclosures represent the first brick in a more complex structure that companies can build thanks to the fair value principle, namely a genuine dialogue with investors and a more fine-tuned management of risk and value creation.³⁶

Conclusion

Understandably, accounting regulators want to define precise accounting standards to guarantee high quality financial statements. By introducing fair value as the bedrock of the accounting system, regulators naturally wanted to have their say in defining it. However, regulators' recommendations appear to have been made without any significant input from financial valuation practitioners.

Despite being crisis measures, the recent amendments are a step in the right direction. The hour of financial realism may be upon us at last. Our task now is to ensure that regulatory and

³⁵ See François Meunier, *les IFRS dans la tourmente des marchés*: SFEV conference, September 25, 2008.

³⁶ On this subject, see Jean-Florent Rérolle and Christian Walter, *For a strategic rehabilitation of financial valuation*, Revue Banque, September 2008. Available on: http://www.rerolle.eu/public/2008b_For_a_strategic_rehabilitation_of_financial_valuation.pdf

standard-setting bodies involve valuation practitioners more closely in formulating standards and recommendations on the topic.

The recent reorganization of the International Valuation Standards Board³⁷ is a perfect illustration of this approach. By adopting a similar structure to the IASB, the IVSB has set itself up as a key player in all international debates on valuation. The Board will give valuation practitioners more preeminence in the revision of future standards, thereby ensuring that fair value principles evolve in step with financial reality.

³⁷ See the IVSC's website: <http://www.ivsc.org/index.html>. The author of this article is also a member of the IVSC's Professional Board.