1 FAIR VALUE CONCEPTS

ALFRED M. KING

UNITED STATES

INTRODUCTION

Being asked to write about fair value concepts for a book with numerous chapters, each dealing with an aspect of fair value for International Financial Reporting Standards (IFRS), by an expert in the field implies that the general editor believes the author has some specialized knowledge of the subject, based on 40 years of active experience. The author will do his best not to disappoint. In this chapter, the terms "fair value" and "fair market value" are capitalized when they refer to the latest definition in the United States.

HISTORIC EXPERIENCE

The concepts underlying fair value for financial reporting draw on the more than 100 years of valuators' experiences. In that context, our activities today bear only a passing relationship to the work performed by our predecessors. Within the past 10 years, major changes have occurred in our firms, as the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have incorporated their ideas of fair value into financial reporting. At the outset, it should be understood that those concepts, as used in both IFRS and generally accepted accounting principles (GAAP), are merely a subset of the more generalized experience developed in the derivation and application of (fair) market value in tax practice in many countries; while the names are confusingly similar, the concepts are very different.

Taxes

The definitions and underlying concepts of the traditional "standard of value," fair market value, cover applications designed to provide useful information for a range of disparate purposes—from insurable values at the high end, through tax amounts, to bankruptcy realizations at the low end. Until quite recently, most valuations pertained, in one way or another, to business transactions.

In fact, there have been three distinct waves of interest in valuation. The original use was not for financial reporting but to determine tax liabilities. In the ancient world, Egypt, Babylon, Greece, Rome, Persia, and China all taxed an individual's or a partnership's assets, which needed a valuator. In those eras, a valuator, serving as a tax assessor, could be a very important individual. Often, after a king died, his ministers were killed and buried with him; in many cases, the tax valuator was the only one spared, as the heir needed that person's knowledge. Later, in the year 10 A.D., China introduced an income tax; fortunately, it soon vanished, until the British reintroduced it in 1798 to pay for their fight against Napoleon; after that, it again disappeared for nearly a century. In the United States, the income tax started in 1861 to finance the North in the Civil War; again, after the conflict, it was dropped

until 1913. During the past five decades, taxation of capital gains has become almost universal, leading to intensification in the use of tax valuations.

Business Transactions

The second use, which soon followed, was to obtain neutral and unbiased conclusions relating to actual or proposed business transactions. Since, by definition, the valuator had no financial interest in the transaction or its outcome, his initial role was that of "honest broker." In 1821, the Hudson's Bay Company, incorporated in 1670, acquired the North West Company, its principal competitor in the Canadian fur trade. As part of the transaction, all the assets of the two entities, in Canada, London, and at sea, had to be valued.

The assistance of a valuator allowed:

- Insurable values to be determined based on professional judgment.
- Buy and sell agreements settled by a neutral observer.
- Purchasers of securities assurance that they were not overpriced.
- Prospective sellers to know the amount at which one asset could be sold, or another item bought, without informing the market about a possible deal.

While there are almost always parties with differing interests in business, when it comes to taxes, appraisers have to be particularly careful not to become advocates. Clients want low figures for property taxes and either high or low, depending on the circumstances, for income taxes. Within the bounds of professional practice, valuators always try to help their clients. By the second half of the twentieth century, the profession in much of the world had split into three branches: real-estate appraisers, business valuators, and security analysts. The contributors to this book include all of them.

Financial Reporting

After centuries, a recent, third step in the use of valuations has arrived: the push by accounting regulators to incorporate fair values into financial statements. Businesses have long been perceived by investors as always looking for the most favorable accounting and financial reporting treatments so as to convey as optimistic an outlook as possible. The increasing use of fair value information is perceived by regulators, analysts, and investors as a more objective approach to financial reporting, a tool that may help or hurt the entity. In turn, this belief has placed great pressure on valuators to arrive at "correct" answers that enhance the objectives of financial reporting.

IASB and FASB have agreed to move toward a convergence of financial reporting standards, with the ultimate objective of GAAP users completely converting to IFRS standards. At the time of writing (March 2009), it appears that the push for rapid convergence, followed by conversion, has slowed down. Nonetheless, it is inevitable that GAAP and IFRS will come together, particularly with respect to fair value information. This chapter deals with the subject as it is currently conceived and used.

IASB, however, has announced that an exposure draft for a new IFRS standard on fair value measurement will be issued in the second quarter of 2009. This is anticipated to follow closely Statement of Financial Accounting Standards (SFAS) 157 with some variations; the expected differences are set out in the appendix to this chapter.

Fair Value

The entire push to fair value accounting and disclosure seems to be predicated on the fundamental assumption that a true estimate of fair value can be developed and disclosed and that the world will be a superior place because of this "better" financial reporting. Unfortu-

nately, that fundamental premise is deeply flawed; massive efforts by many professionals have failed to communicate that valuation involves a vast amount of judgment. Therefore, any fair value conclusions are far from precise and perhaps not even totally reliable.

Analysts, accountants, and standard setters have trouble with the idea that the same asset can have different values for different owners or for different purposes. Accountants consider their activities, though many involve assumptions, estimates, and judgments, to be precise and expect that valuation should have equal "precision." Of course, as those who actually perform valuations know, the very concepts of Fair Value or Fair Market Value are difficult to pin down.

IMPORTANCE OF JUDGMENT

This section discusses the role of judgment in the determination of each of the two separate concepts, which have many critical differences. After the profession had spent over 100 years developing Fair Market Value, in June 2001, FASB introduced fair value with SFAS 141, followed in September 2006 with a new definition in SFAS 157, which totally changed the fundamental concept and instituted a brand-new approach to value, as discussed subsequently. In general, IASB has been an acquiescent follower.

Professional judgment is always involved in a valuation, even if only with respect to knowledge of the asset or business; no one would hire a real estate specialist to determine the fair market value of antique furniture, nor a financial expert for insurable values of machinery or equipment. However, these distinctions, while well known and understood, deal only with training and experience. A different, also important, kind of judgment, which users of valuation information often disregard, is that normally there is really not a single answer but a *range* of correct answers in any specific valuation situation, whether for real estate financing, placement of insurance, or an allocation of the purchase price in a business combination.

Valuators have created the regrettable situation where clients receiving an appraisal report feel that the indicated amount is in fact "the" value. Most end up with a single-point estimate, a number that is sometimes carried to five significant figures; such deterministic answers actually promote confidence because of their seeming precision. However, in our view, this aura of precision is the cause of much of the discussion regarding weaknesses in fair value, its determination, and its use in financial reporting.

In the course of an assignment, every skilled appraiser inevitably has to make many individual decisions. These choices—and they are choices—rarely show up in the narrative reports and certainly are invisible to those reading them. If two equally skilled valuators were given the same assignment but did their work entirely independently, it should not surprise anyone that their conclusions may differ. Yet many ordinary nonprofessional recipients *are* surprised when two seemingly equal valuators come up with conflicting amounts; in this author's view, they should be within 10 percent of each other, but not necessarily any closer.

The target audiences for the realities of valuation have to be (1) setters of accounting standards; (2) auditors who try to make sure that complex accounting rules are being faithfully followed; and (3) preparers of financial statements. Those groups, however, still generally believe that there is a single "true" fair value, which should be determined and then disclosed. That the same asset can have far differing values to various people for diverse purposes is not yet fully accepted. When preparers of financial statements complain about the difficulty and cost of obtaining fair value information, or protest about its relevance, some security analysts and academics often assert that "the company does not want to disclose Fair Value because they have something to hide."

There are at least three different premises of value: value in use, value in exchange, and value in liquidation. This fact has not prevented FASB from putting unwarranted emphasis on value in exchange in "active markets." Fortunately, IASB has not yet followed suit and also includes in its impairment testing "value in use"; this is normally "entity specific" yet often most relevant to actual market participants.

FAIR VALUE VERSUS FAIR MARKET VALUE

For many years, there has been a standard definition of Fair Market Value (slightly different between Canada and the United States) developed for the International Glossary of Business Valuation Terms by a group of North American valuation organizations, including the National Association of Certified Valuation Analysts, IACVA's U.S. charter and the American Institute of Certified Public Accountants (AICPA). 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. (NOTE: In Canada, the term price should be replaced with the term highest price.)*

The International Valuation Standards Council (IVSC) has a definition of Market Value used in much of the rest of the world; this is similar in that it deals with an arm's-length transaction between a willing buyer and a willing seller:

> *The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.*

The first definition, or one conceptually very close to it, served the valuation profession and clients in the United States and Canada without controversy for over 100 years; in it, "fair" qualifies "market," not "value." The very similar concept, called just "market value," dates back centuries in Europe. These definitions acknowledge that different premises of value can coexist depending on the purpose of the assignment and the interests of the parties while insisting that the perspectives of both buyer and seller had to be explicitly recognized. Therefore, various views about the future outlook still could result in diverse conclusions of value.

Business Combinations

In a business combination, valuators should deal with the actual economics of the specific transaction. "What did the buyer acquire?" "Why did he pay that particular price?" Different buyers for the same business potentially would have distinctive allocations of the same purchase price. That seems both realistic and in accord with the actual decisions implemented by a real exchange of funds; initially FASB and IASB seemed to agree. In 2001, on FASB's introduction of the term "fair value," its definition in SFAS 141, *Business Combinations*, did not mention arm's length but dealt with willing parties:

> *The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.*

A number of IFRSs, which at the time of writing are still in force, use the next definition. It is closer than SFAS 141 to Fair Market Value and market value as it includes both the arm's-length principle (see "Transfer Pricing") and willing parties; also, it does not confuse readers with references to liabilities:

The amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction.

SFAS 157

In September 2006, FASB radically changed established valuation practices in the United States with the issuance of SFAS 157, *Fair Value Measurements*, which amended the definition of Fair Value to make it an "exit" price:

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.

All references to "arm's length" and "willing parties" are totally gone, and the application to liabilities is no longer only in brackets. However, between this definition of Fair Value and that of Fair Market Value, there are two key differences; they are equally important in the way the terms are defined and used and they cause severe dislocations to the usual concepts of valuation. Subsequent interpretations based on this new definition have created additional problems, both in valuation and in financial reporting.

At the time of writing, IASB has not yet adopted the SFAS 157 definition of fair value but appears to be moving in that direction. The balance of this chapter assumes IFRS will, in the name of convergence, adopt a very similar definition. Many commentators wish the convergence would go the other way. While the discussion is primarily based on U.S. experience, there is no reason to believe that IFRS will take a different direction. It should be pointed out, however, that FASB did not apply the SFAS 157 definition to fair value with respect to SFAS 123R, *Share-Based Payments*.

Exit price. The main distinction in the differing concepts of value is that for Fair Value, the premise is solely from the viewpoint of the seller, i.e., what it would receive on the sale of the asset, while Fair Market Value, with its "willing buyer" and "willing seller" components, takes both perspectives into account. In practice, fair value may lead to results that are hard to understand and even harder to explain. As an example, assume at a Christie's art auction the last two buyers are competing for a Rembrandt with bids going up in increments of $1 million. At $29 million, one drops out, and the remaining bidder wins the picture at $30 million.

Most observers would think the Fair Market Value of the painting had just been established at $30 million, as there was a willing buyer (successful bidder) and a willing seller (consignee), neither being under compulsion, and it can reasonably be assumed that both had equal knowledge that the picture was genuine. However, under SFAS 157, the Fair Value is only $29 million, as it has to be appraised at what it could be sold for to another "market participant." There is a willing buyer at $29 million (the bidder who dropped out) and no one else will pay $30 million because the winner was the last man standing.

This is the first major problem with the FASB concept of Fair Value. The definition creates an anomalous situation in that the winner bought the painting for $30 million and its "Fair Value" is only $29 million, an apparent instant loss of $1 million, which actually would be reflected in goodwill as an "overpayment." This is referred to as the "Day 2" problem, when a buyer acquires an asset and is forced to value it at what *someone else* might pay for it. This was pointed out to FASB during its deliberations; it heard and understood the implications but declined to change the definition.

In addition, there is the problem of "transaction costs." Under conventional accounting, for over a century, the costs of purchasing and installing an asset have been capitalized together with the purchase price; IFRS 3 and SFAS 141 both treated them as part of the "cost of the acquisition" and allocated them to the assets acquired, including goodwill and liabilities assumed. This is no longer true for business combinations as they do not form part of fair

value; therefore, IFRS 3R, following SFAS 141R, requires acquisition costs to be charged to earnings. In the case of the Rembrandt just discussed, Christie's 10 percent "buyer's premium" might have to be charged to earnings.

Market participants. The second unique twist to the FASB definition of Fair Value is that it is not measured by what the actual buyer really paid. Instead, valuators have to try to determine what some *other* hypothetical market participant *might* pay. This moves "values" from real prices in actual transactions to a notional world of hypothetical market participants paying theoretical prices.

Throughout SFAS 157 and in many other communications, FASB has clearly stated that it does not like, or trust, values developed or based on "entity-specific" assumptions. In other words, not only is what the firm actually did not important, but the reasons for the amount paid are dismissed as potentially misleading. It is disconcerting to management when a valuator tries to explain why he or she cannot, in good faith, use the actual transaction price. Fortunately, IFRS considers "value in use," established by discounting cash flows, using entity-specific assumptions as well as "fair value less costs to sell" in determining impairment losses.

Trying to arrive at values based on what some market participant *might* do is difficult, as there is not always a clear understanding of just who those market participants are. SFAS 157 defines "market participants" as "buyers and sellers in the principal or most advantageous market for the asset or liability." They are also supposed to be:

- Independent of the reporting entity
- Knowledgeable (having all relevant information, including results of usual and customary due diligence)
- Able to deal and willing (motivated but not compelled) to transact

This is very unsatisfactory; despite thousands of deals every year, there is no organized "market for corporate control," much less for most intangible assets. Therefore, market participants would appear to be every potential purchaser, starting with all competitors and going on to include any trade or financial buyer who, based on past activities, might be interested.

Purchase Price Allocations

Purchase price allocations are supposed to be performed using the assumptions that a market participant would make. For example, Exclusive Auto buys Super Body, both auto parts suppliers, as a strategic acquisition. Should the seller's customer relationships be ascribed a high or low value? From the perspective of the actual buyer who is dealing with the same customers, they have little value. If all market participants were deemed to be trade buyers, then the valuator would be justified in assigning them a low figure, with more of the purchase price as nonamortizable goodwill.

If, however, the "market participants" were deemed to be "financial buyers," the answer would be very different. Such purchasers have few contacts in the industry, and therefore, the seller's customer relationships would be critical and have a higher value. As intangible assets must be amortized over their useful lives, the larger the amounts assigned to them, the greater the negative effect on reported earnings. How does a valuator determine who the *appropriate* market participants are? Are they strategic or financial buyers? Obviously, the choice affects not only the purchase price allocation but also the subsequent reported earnings of Exclusive Auto, the purchaser.

The second problem with the SFAS 157 definition of fair value is now apparent. Suppose management says, "We think all the other buyers would be competitors at present in this industry, so let us assume that for the valuation." At that point, the auditor, or later a

regulator, can challenge the assumption and say, "Well, no, in *our* opinion, the only realistic market participants are financial buyers; therefore, you must assign a high value to the customer relationships." All too often the auditor, who must sign off on the values in the financial statements, digs in his heels and insists on following his inclination, even though there may be no more support for that view than the client has for its view; meanwhile the valuator is caught in the middle.

HOW DID WE GET HERE?

Why would FASB, in full consultation with IASB, throw out over 100 years of experience with Fair Market Value and substitute its own new and unique definition of Fair Value? The answer is straightforward and understandable, but a result of the law of unintended consequences. The reasoning can be traced back directly to the Sarbanes-Oxley Act (SOX), enacted by the United States Congress in 2002, following a series of financial reporting scandals in which managements distorted GAAP. The objective of SOX was to preclude any future such disasters. A key element is the requirement that senior management personally sign a report confirming that the entity had an effective system of internal controls; this, in turn, has to be attested to by their independent auditor.

Congress then ordered the Securities and Exchange Commission (SEC) to develop standards for reporting value information by its registrants. In the United States, the SEC has the power to determine auditing and accounting standards; for accounting, this is delegated to FASB. Many of the FASB staff had experience with a number of standards that are concerned, in one way or another, with current values of financial instruments. Over the years, numerous problems in such matters had been dealt with by FASB staff and board members. As a result, they had become experts with regard to the fair value of financial instruments. After deliberation, FASB reached the conclusion that a new definition of fair value, one suitable for financial instruments, would be equally valid for all assets, including intangibles. Unfortunately, the characteristics of many assets like intangibles and some machinery and equipment simply do not fit that mold.

MARKET APPROACH FOR FAIR VALUE OF FINANCIAL INSTRUMENTS

Many accounting problems surfaced after the Enron debacle; a major enterprise with 22,000 employees that claimed revenues of $101 billion in 2000, it collapsed into bankruptcy in 2001 as a result of major frauds, including numerous misuses of fair value. Put simply, Enron created its own financial derivatives, for example, selling a contract to provide electricity to various entities at agreed-upon prices for 20 years. It owned an electric generating plant and was confident that it could produce power at an assumed rate of $0.08 per kilowatt-hour (k-Wh). Meanwhile the customer agreed to pay an assumed rate of $0.10 per k-Wh. This contract seemingly assured Enron a guaranteed profit of $0.02 per k-Wh on all the electricity it covered. A very large number was developed for the present value of this contract, and the total anticipated 20-year profit stream was taken into income during a single quarter!

This was too good to be true, and it was, if the new FASB definition of Fair Value had been applied. Enron had developed and valued the contract on its own. It did not test the conclusion by going to market participants—in this case, investment banks like Goldman Sachs or Morgan Stanley—and asking them what they would pay to purchase the contract. The new FASB definition, had it been in effect, would have precluded Enron from generating its own earnings through its internally generated instruments. With no outside test of the true economic reality, Enron was able to comply with the then-current rules, and the auditors had no basis to question their values. SFAS 157 was a real step forward for financial instru-

ments; the exit value/market participant combination was both necessary and sufficient to shut down those kinds of games.

Unfortunately, FASB, when asked by the SEC to tackle the difficulties of the previous definition of fair value, had no experience with, or knowledge of, valuation practices for physical or intangible assets. Therefore, it assumed that what worked for financial instruments should be equally valid for all other assets and liabilities.

RELEGATION OF COST AND INCOME APPROACHES

This is the reason behind SFAS 157's definition and why it places primary emphasis on the Market Approach and downgrades the Cost and Income Approaches. If an active market exists, the Market Approach should be used for financial instruments. For other assets, the situation is more complex. Commercial and industrial real estate, of course, often has many buyers and sellers; in the markets, plant, machinery, and equipment have a number of participants, mostly specialist dealers and numerous auctioneers, but they all tend to be limited in scope. Intangibles, due to their unique characteristics, have virtually no market participants. Valuators therefore have consistently used the Cost and Income Approaches for these asset categories.

Under Uniform Standards of Professional Appraisal Practice (USPAP), which covers real estate valuations in the United States, appraisers must consider all three approaches. If one or more is not used, an explanation is required in the report. In a desire for a one-size-fits-all approach to Fair Value, FASB turned this fundamental principle of valuation upside down. It knew the Market Approach was best for financial instruments and once again assumed the same rules should apply to all.

FASB's discomfort with entity-specific amounts, such as value in use based on the owner's intentions, which IASB accepts in part, can also be traced back to the financial scandals of 2000 to 2002. Entities played games with financial reporting, claiming to be within GAAP, even though the final results were positively misleading.

SFAS 157 is explicit that only market data are considered as "Level 1" or "Level 2" inputs in evaluating the strength and relevance of the valuation information being disclosed. Whenever a valuator uses the Cost Approach or Income Approach, then SFAS 157 automatically places the inputs and resulting conclusions of value in Level 3. Further compounding the problem is that many security analysts believe that Level 1 and Level 2 values can be trusted while organizations descending to Level 3 must have something to hide.

AUDITING FAIR VALUE

As mentioned earlier, professional judgment is inherent in the valuation process. If, as previously stated, two equally competent appraisers should come within 10 percent of each other, this still leaves substantial leeway, particularly for auditors who aim at precision. Put another way, despite the seeming precision of many valuations—where the answer is carried out to four or more significant digits—in practice the "true" answer is nearly always within a range of 5 percent more or less.

The essential element of valuation is that it looks to the future to estimate the cash flows anticipated to be derived from the asset(s); those are then discounted back to a present value. Future developments are always uncertain, and best estimates of them are generally wrong. Hindsight is less likely to support previous assumptions than to show up flaws in earlier judgments. Valuations are audited after the fact, when it is easy to poke holes in the original beliefs. Even if the audit is contemporaneous, it is all too easy to ask "Why did you assume this?" or "Why did you not consider that?" Since valuation involves significant professional

judgment, it is easy to see how even highly experienced auditors can and will make different decisions in good faith.

Auditors like to validate what they examine (the purchase of a lathe is confirmed by reviewing the invoice); they find it frustrating when they cannot put "proof" of a valuation into their working papers. In some countries, such as the United States, this problem is even more serious, because regulators periodically review the working papers of the auditors of publicly traded entities. A year or so later, it is easy for a regulator to ask "How did you accept this valuation report prepared for the client? Why did you not verify the assumptions used by the appraiser?" One or two cases like this will make all the auditors in a particular office question every valuation report. This is extremely annoying, because, at the end of the day, it is not possible to audit professional judgment. An auditor can, and should, question the appraiser's assumptions or suggest that another methodology would produce a different answer. However, the auditor can no more prove his or her (different) answer is correct, and the valuator's original conclusion wrong, than vice versa; this fact frustrates auditors and valuators.

MARK-TO-MARKET ACCOUNTING AND FAIR VALUE

In late 2008 and early 2009, questions about the proper valuation of financial instruments hit the headlines. The application of SFAS 157—exit price and market participants—to the wide range of subprime mortgages and financial derivatives threatened to bring down the banking systems in many countries. Calls were heard to repeal mark-to-market reporting because, it was asserted, the system had created a death spiral. Some institutions had to sell certain assets at distressed prices; in turn, those were taken to be the "market," and auditors pressured other banks to write down their holdings to such lower amounts. The required impairment charges then reduced bank capital, forcing additional sales, which drove prices even lower, with no end in sight.

Some frustrated bankers wanted to abolish mark-to-market accounting altogether. In its place, financial instruments would be valued by "models" to account for anticipated future cash flows; in other words, they would disregard actual prices and substitute theoretical values. Needless to say, FASB, IASB, and the SEC fought this proposal tenaciously.

What most observers failed to realize was that the SFAS 157 rules on "market" transactions should not be applied to forced or liquidating sales, which are those made by an unwilling seller and do not represent Fair Value. Local assessors base the value of your house neither on a foreclosure sale next door nor on an estate sale across the street, because they know that neither is Fair Market Value. Only transactions between truly willing buyers and sellers should establish fair value. Regrettably, the definition in SFAS 157 uses the word "sell"; auditors, reluctant to have their clients apply judgment, found it all too easy to force them to mark their securities to the last reported sale, even though it totally failed the test of true Fair Value.

The real flaw of mark-to-market accounting is in determining what the market was or is. Using an inappropriate transaction as indicative of a Fair Value transaction, which some auditors demanded in fear of being second-guessed, is what really drove the so-called death spiral. It was not bad accounting, merely bad valuation. At the time of writing, FASB and IASB have come up with staff positions regarding inactive and not orderly markets suggesting why recent reported transactions may or may not be indicative of Fair Value. They are encouraging companies to apply judgment. Now it will be seen how comfortable auditors are in trying to audit that.

PROBLEMS WITH FAIR VALUE—AND POLITICAL SOLUTIONS

The issuance of certain IFRS has caused individual governments to "exempt" their national firms from the full rigor of those accounting requirements. In such situations—and admittedly they are relatively infrequent—political decisions are made about technical issues. In the United States, certain members of Congress have threatened the independence of FASB "unless they straighten out the situation." Although it would be comforting to think that accounting and valuation issues can be determined by professionals in an unbiased manner, in the real world, this is unlikely. Whenever such rules are perceived to have actual economic consequences—producing winners and losers—there is a rush to the ramparts by politicians trying to save their constituents from unpleasant and potentially damaging situations.

That FASB developed its own new definition of Fair Value, which IASB seems likely to adopt, is an indication that arbitrary changes to well established traditions can be undertaken with the best motives in the world. Unintended consequences then cause an equally arbitrary reaction. Depending on the political strength of the parties, the standard setters usually will be upheld, but sometimes they are overturned. Once an arbitrary definition of Fair Value was adopted, no one should have been surprised that there were real-world consequences. Some may have welcomed the changes; others viewed them with alarm. The one thing that is certain is that within the next few years, there will be major changes in financial reporting and the development and use of value information in financial reporting. No one can predict the specific outcomes, but for the valuation profession, these will be, as the Chinese say, "interesting times."

IMPLEMENTING FAIR VALUE

The next exhibits are a series of flow charts on implementing Fair Value under SFAS 157, whose definition is likely to be accepted by IASB. They are reprinted with permission from *Business Combinations with SFAS 141R, 157 and 160—A Guide to Financial Reporting* by Michael J. Mard, Steven D. Hyden, and Edward W. Trott (Hoboken, NJ: John Wiley & Sons, 2009).

The first flowchart summarizes the various steps whose details are on the next five charts.

Exhibit 1.1 Subjects of the Charts

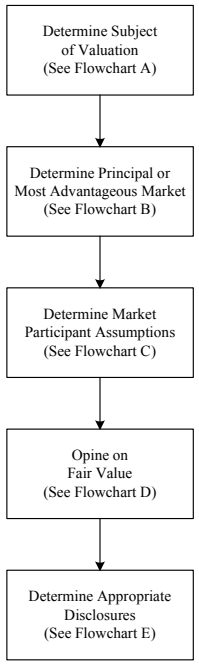


Exhibit 1.2 Flowchart A: Subject of Valuation (Asset or Liability and Unit of Account)

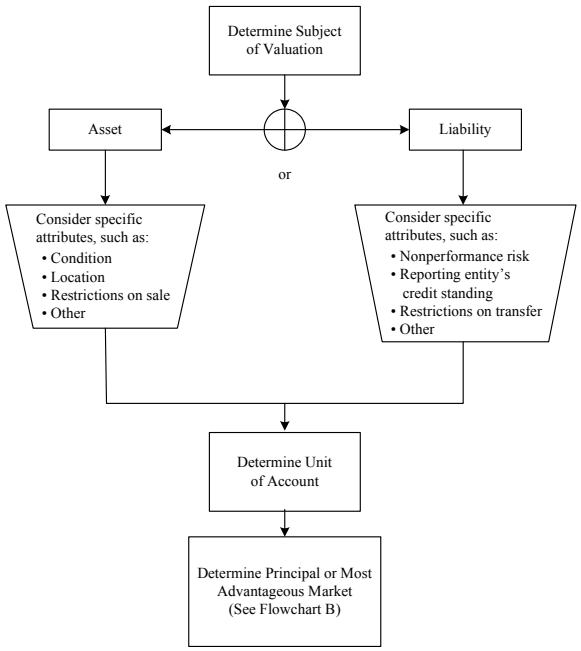


Exhibit 1.3 Flowchart B: Principal or Most Advantageous Market

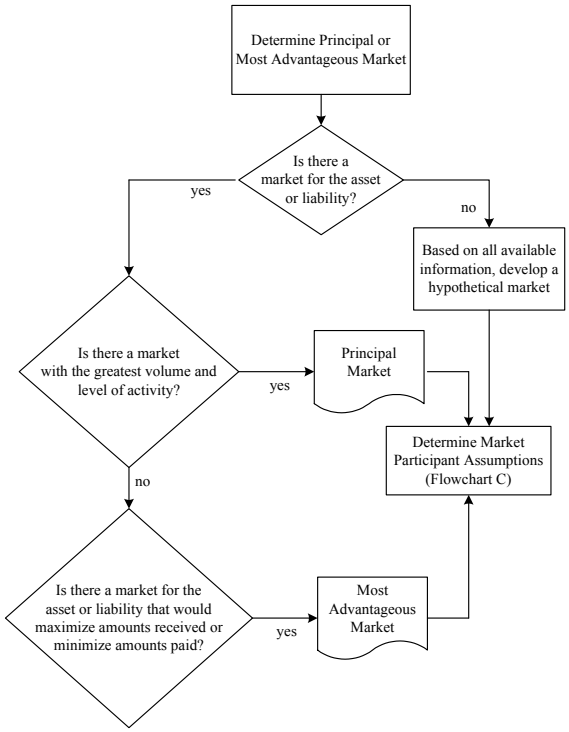


Exhibit 1.4 Flowchart C: Market Participant Assumptions

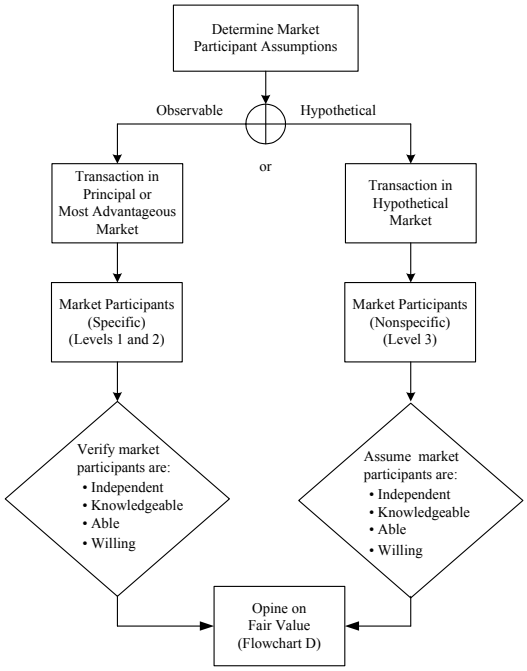


Exhibit 1.5 Flowchart D: Fair Value Measurement

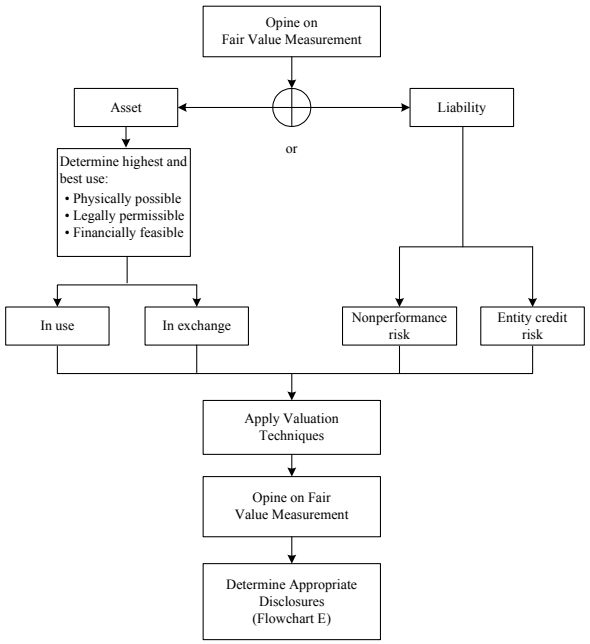
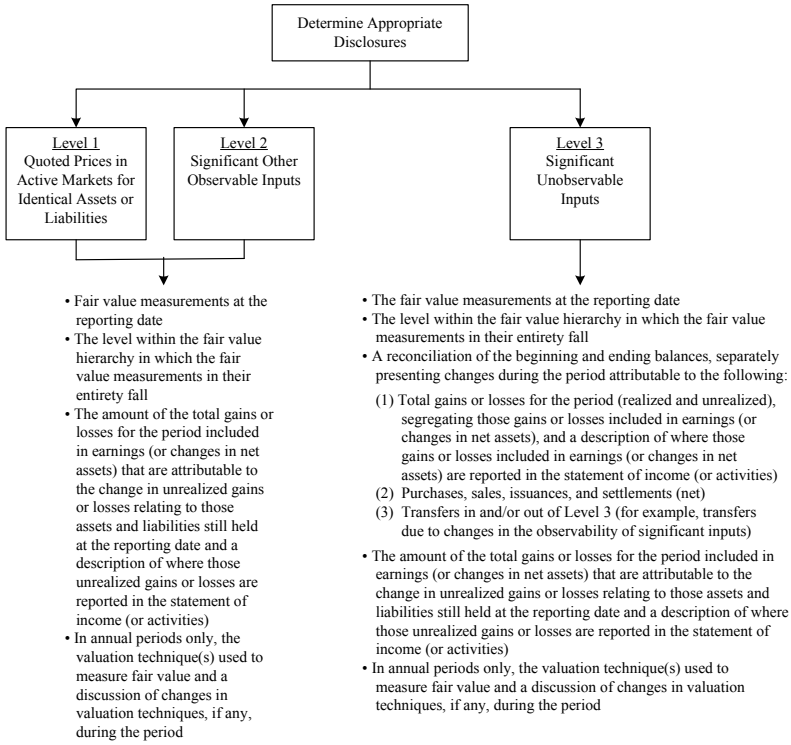


Exhibit 1.6 Flowchart E: Appropriate Disclosures



POSTSCRIPT

This chapter was written in the spring of 2009. By late January 2010, a number of significant developments, described in this postscript, had occurred. As expected, IASB, in May 2009, issued an Exposure Draft (ED), *"Fair Value Measurement"* on which it received 156 comment letters, including one from the General Editor. This ED reflected FASB's view, set out in SFAS 157, *Fair Value Measurement*, that Fair Value was an exit price, while continuing to reflect the exchange notion previously adopted by IASB. The proposed new definition 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.*

Responses to the ED

Nearly all the responses to the ED were in favor of the document's concept and the resulting likelihood of full worldwide convergence as to valuation guidance. Most think the proposed definition as an exit price, is acceptable because it retains the exchange notion in the current definition and sets out a clear measurement objective.

Other significant comments were:

- The exit price concept is not relevant for an asset which an entity does not intend to sell as (a) it is being used in the operations of the business or (b) it is a financial asset that is not held for trading
- Fair value is an appropriate measurement basis only for assets and liabilities that are initially and subsequently measured using it
- The proposed guidance is most appropriate for financial instruments and not as much for physical and intangible assets or liabilities
- A liability should reflect a settlement rather than a transfer price if it cannot legally be transferred or if the entity does not intend to do so
- There may be major problems in applying the concept in emerging and transition economies where there are limited markets and few valuators

January 2010 Joint Meeting with FASB

At an IASB/FASB joint meeting in January 2010, the following topics related to fair value measurement were discussed at length:

1. Definition of fair value
2. Measuring fair value when markets become less active
3. Fair value at initial recognition
4. Recognition of day one gains or losses
5. Measuring liabilities at fair value
6. Nonperformance risk
7. Restrictions on the transfer of a liability
8. Measuring own equity instruments at fair value
9. Market participant view
10. Reference market

The tentative decisions then taken, which are summarized below, are expected to be reflected in a new converged standard to be issued in 2010Q3; this is not likely to be effective before 2012.

1. *Definition of fair value*

   To retain the term *fair value* and to continue to define it as an exit price. The Boards will discuss in a future meeting where that definition should be used, when they address the scope of a converged fair value measurement standard.

2. *Measuring fair value when markets become less active*

   The guidance for measuring fair value in markets that have become less active pertains to when there has been a significant decline in the volume and level of trading in the asset or liability. It should focus on whether an observed transaction price is orderly, not on the level of activity in a market. An entity should consider any observable transaction prices unless there is evidence that the deal is not orderly. If there is not sufficient information to determine whether a transaction is orderly, further analyses should be undertaken to measure fair value.

3. *Fair value at initial recognition*

   The transaction price may not represent the fair value of an asset or liability at initial recognition if, for example, any of the following conditions exist:

   a. The transaction is between related parties
   b. It takes place under duress or the seller is forced to accept a price
   c. The unit of account represented by the transaction is different from the unit of account for the asset or liability measured at fair value
   d. The market in which the transaction takes place is different from that in which the entity would sell the asset or transfer the liability

4. *Recognition of day one gains or losses*

   The Boards will discuss this at a future meeting.

5. *Measuring liabilities at fair value*

   In the absence of a quoted price in an active market representing the transfer of a liability, an entity should measure the fair value of a liability as follows:

   a. Using the quoted price of the identical liability when traded as a corresponding asset (a Level 1 measurement)
   b. If that price is not available, adjusting quoted prices for similar liabilities or similar liabilities, when traded as assets (a Level 2 measurement)
   c. If observable inputs are not available, using another valuation technique such as:

      (1) An income approach (for example, Discounted Cash Flows method, including the compensation a market participant would demand for taking on such an obligation)
      (2) A market approach (for example, the amount that a market participant would pay to transfer the identical liability or receive to enter into it).

   d. An entity must determine if the fair value of a liability when traded, whether or not on an exchange, as a corresponding asset represents its fair value. When an entity determines that the fair value of the corresponding asset does not represent the fair value of the liability, it must make adjustments to the fair value of the asset to offset the extent that its fair value does not represent that of the liability, in particular:

(1) The fair value of the corresponding asset should be measured using a method market participants would apply
(2) A quoted price for a corresponding asset in an active market is a Level 1 measurement for the liability when no adjustments are required
(3) The transfer of a liability assumes that a market participant transferee has the knowledge and ability to fulfill the identical obligation

6. *Nonperformance risk*

   The fair value of a liability includes the effect of nonperformance risk; the Boards agreed to clarify what, in addition to credit risk, nonperformance risk represents.

7. *Restrictions on the transfer of a liability*

   The fair value of a liability should not be adjusted further for the effect of a restriction on its transfer if that factor is already included in the other inputs to the measurement.

8. *Measuring own equity instruments at fair value*

   Further guidance for measuring the fair value of an entity's own equity instruments will be provided.

9. *Market participant view*

   Fair value is market based and reflects the assumptions that market participants would use in pricing the asset or liability. In particular:

   a. Market participants should be assumed to have a reasonable understanding about the asset or liability and the transaction based on all available information, including that which might be obtained through usual and customary due diligence efforts
   b. "Independence" of market participants means that they are unrelated to each other as well as the entity
   c. A price in a related-party transaction may be used as an input to a fair value measurement if the transaction was entered into on market terms
   d. The unobservable inputs derived from an entity's own data, adjusted for any reasonably available information that market participants would take into account, are considered market participant assumptions and meet the objective of a fair value measurement

10. *Reference market*

    The reference market for a fair value measurement is the principal (or most advantageous) market provided that the entity has access to it. The principal market is that with the greatest volume and level of activity for the asset or liability; it is presumed to be that in which the entity normally transacts; there is no need to perform an exhaustive search for markets that might have more activity than that one. The determination of the most advantageous market should consider both transaction and transportation costs.

There undoubtedly will be more developments in 2010.