

Defining Fair
by Douglas McKnight
April 3, 2009

On April 2, 2009, the New York Stock Exchange Composite Index (NYSE Composite) surged by 3.48%, the National Association of Securities Dealers Automated Quotation (NASDAQ) index surged by 3.29%, and the Dow Jones Transportation index surged by a whopping 7.76%. These were widely attributed to a small change in the definition of value in an accounting rule. This definition had been the center of controversy for months, with some commentators blaming the entire financial crisis on it. The popular name for this is mark to market.



The controversy revolves around the definition of the term “fair value.” The term itself is a misnomer. All values ultimately boil down to subjective value, which is the value of non-durable consumer goods and services to an individual. Money can’t buy you love, but for any goods or services that can be purchased, subjective value is determined by the perceived importance of the good or service to that person’s well being, something that economists call marginal utility, relative to that person’s available funds. The market values of capital assets, such as commercial real estate, machinery and equipment, and intangible assets - including securities - are determined by the dollar volume of consumer goods that they can produce. These values are neither fair nor unfair, they simply are.

Nonetheless, the accounting profession has chosen to use the term “fair value” to describe their version of market value.

Fair value is one of two types of values that are used in accounting for capital assets. When one company buys another company, all of the assets are appraised at fair value and the accounting records are changed from book value to fair value. Fair value is also used in accounting for mortgage-backed securities.

Prior to September 2006, the term “fair value” was essentially undefined. The Financial Accounting Standards Board (FASB) used the term throughout various accounting standards but defined it in different ways in different standards and left it undefined in others. They wanted to remedy this situation by creating one definition that would apply to all standards. The result was Financial Accounting Standard (FAS) number 157. They approved this standard in September 2006 and originally scheduled it for implementation in November 2007.

By the time November 2007 rolled around, however, FASB decided that it needed more time. They delayed the required implementation of the standard for another year, although firms were encouraged to implement the standard between November 2007 and November 2008. The required implementation of the standard took place in November 2008.

The controversy emerged even before the required implementation date. Although FAS 157 did not change any of the assets that were accounted for using fair value, it did mandate, for the first time, what valuation techniques to use. These valuation techniques are nearly identical to the methods that the appraisal profession has been using for decades. It established that fair value did not represent a distressed

sale, but only applied to an “orderly transaction.” The standard also introduced a fair value hierarchy. The hierarchy consisted of three levels.

Level one assets are those that are regularly traded in active markets and are to be accounted for at their quoted prices. Level two assets are those with less-actively traded markets but with available market data that can be used in order to arrive at a professional opinion of fair value. These assets require an appraisal. Level three assets are those for which there is no market data. These are to be valued using “unobservable inputs” by which they mean unsupported assumptions.

The contention of those opposed to FAS 157 was that the classification of assets as level one or level two was causing inappropriate write-downs of assets. The truth was that these people had welcomed fair value accounting when it indicated that the values of their assets were increasing but were opposed to it when it indicated that the values were decreasing.

The catalyst for the April 3, 2009 stock market surge was the approval of FASB staff position 157-e. This document gave companies additional discretion to decide whether the markets for their assets were active or inactive and whether or not a particular transaction was distressed. The idea of some investors was that by changing the basis of reporting from price quotes and professional opinions based on available market data to unsupported assumptions, the market value of assets would increase.

The reality is that smart investors read the all of the financial statements, not just the bottom line of the balance sheet. The only thing that FASB accomplished with 157-e was to make it a little harder for investors to discover the true financial condition of a company. The success of a company comes from their successful operations, not from their accounting standards. However accurate accounting, in good times and bad, can improve the trust that investors have in a company. All of the one-day gains in the market indexes will be lost in the coming months as investors realize that the success of a company depends on results and that obscuring these results ultimately causes a drop in the value of the company.

The final word on this controversy is that all of a company’s assets that they report at fair value should be accounted for as level one or level two assets. Successful companies that do this will find that their value will increase in the long term. It also showcases the importance of insisting that the firm that you engage to appraise your level two assets uses the proper definition of value. Too many appraisal firms are using market value definitions instead of the FASB definition of fair value when appraising assets for accounting purposes. Hard work and honesty will pull us out of the financial crisis. Dishonest attempts to alter reality won’t.