

DATA & PUBLICATION UPDATE

AI King Takes Apart Fair Value for CFOs—and Puts It Back Together Again

***The Executive's Guide to Fair Value: Profiting from the New Valuation Rules*, by Alfred M. King (Wiley, 2008)**

Review by Warren Miller, CFA, ASA

This is a great book, not just for CFOs but also for valuation professionals. You'll want to be able to discuss it when you see a copy on the CFO's desk at your favorite client or referral company.

King's latest release updates and redirects the focus of its predecessor, *Fair Value for Financial Reporting: Meeting the New FASB Requirements* (Wiley, 2006), which was aimed at valuation professionals. This new book targets those who retain valuation professionals. At the outset, King owns up to being an outspoken critic of the FASB's fair value pronouncements and perspectives, including its "exit value" stance. "I am unalterably opposed to many of the actual and prospective uses of Fair Values, as defined by the FASB," he writes, while at the same time he concedes standing to benefit financially from FASB's approach. He then disclaims any intention of trying to put the fair value "cat" back into the FASB bag. He keeps his word.

Difficult to alter current FASB course

King—a former executive director of the Institute of Management Accountants, retired chairman of Valuation Research Corp., and current vice chair of Marshall & Stevens, Inc.—has forty years of valuation experience. He draws on that

wealth of insight and institutional knowledge throughout the book, including Chapter One's explanation of how fair value came to fruition. The causes are "the Enron experience" and "pure accounting theory," he says. The former resulted from insiders valuing derivatives that they had created, while the latter came to the fore during the high-inflation 1970s. "Inflation destroys accounting comparability," King observes.

Most readers of this book, he adds, share the general management view that "the Income Statement should represent what management has done with the shareholders' assets." So long as the Income Statement reflects current performance, most executives are willing to let the Balance Sheet be "a residual."

Unfortunately, however, the Board members and staff of the FASB do not share the management perspective. Their view is that the Balance Sheet is important, that it should be correct, and that correct Balance Sheet amounts should be based on current values. This is their reality. It is easy to find fault with the Board's assumptions and approaches, but very difficult to get them to change their minds.

King also identifies what might be described as the Bonnie and Clyde of fair value: *exit price* and *market participants*. He promises to show corporate executives "how to minimize the adverse consequences" of the new fair value requirements, even as he notes in one of the book's many sidebars that the new FV rules "actually provide very substantial room for potential manipulation of reported financial results." That is because changes in fair value on the Balance Sheet are required to be reported not as "Comprehensive Income," he explains, but on the Income Statement itself.

Continued to next page...

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...continued from front page

King also emphasizes for his audience that an asset “can have several different fair values, depending on the purpose for which the value is being developed.” Even though a single “point estimate” is typically used in fair value valuation reports, the “true” fair value is actually a range. Absent other information, most appraisers choose the midpoint of the range, but they can—and sometimes do—choose a value

at either end of the spectrum to accommodate a client. While this might sound like advocacy, King is careful to point out that valuation professionals often say they’re lucky if their estimates are within 10% of the “real” value. What difference does it make where the point estimate falls within a 10% valuation range? King is careful to contrast accommodating a value within a range to producing a point estimate that is MAI (“Made as Instructed”).

Range of fair value topics

In the next chapter, King takes his readers through the different business valuation approaches and methods. For example, he deals artfully with the question of how appraisers handle DCF projections that might well be confused with fantasy, and he decries the reliance on EBITDA by investment bankers. In a subsequent chapter, King contrasts how valuation in litigation should happen (objective and irrelevant of client’s and attorney’s wishes) with how it usually happens (MAI). He discusses buy-sell agreements and how periodic, non-formulaic valuations can help companies stay out of court.

A short chapter covers accounting for mergers and acquisitions, in which King does a nice job of tying valuation results to profit and loss statements (P&Ls), pointing out that most acquirers prefer having non-amortizable assets to amortizable ones. And for anyone who does a slug of M&A work, King’s chapter on due diligence will be a joy. It emphasizes the importance of retaining a specialist to do a PPA (purchase price allocation) *before* the transaction is agreed to. This chapter also extols the virtues of hiring a third party to go over the target company with a fine-toothed comb, to give board members better objectivity about value than they might otherwise get from their buy-side insiders, who often have incentives to close the deal. After pointing out that the third party’s “fair values” might not be the same as those that occur in a PPA, King takes the opportunity to assert that the FASB

Continued to next page...

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Al King Takes Apart Fair Value

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has abandoned 115 years of history of relying on arms'-length transactions as a basis for determining value.

Elsewhere in the book, King covers: valuation of different assets and liabilities for different purposes; more on PPAs; impairment testing; and that old SEC bugaboo, customer relationships.

His last chapter focuses on selecting and working with a valuation professional, and the Appendix contains a redacted report, which his target audience should find helpful. Throughout the book, King wisely implores readers to read *all* of a valuation report, not just "the number," which his valuation readers will appreciate.

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