

# The New Rules for Fair Value

By Alfred M. King

## Appraisers:

**A new Sheriff just rode into town! The rules of our game are changing, perhaps permanently.**

Until recently, appraisers had to follow USPAP and the IRS guidelines for an appraisal to stand up to scrutiny. Courts would look at an appraiser's qualifications and then make sure that the appraisal report had been properly prepared in accordance with USPAP and previous court decisions.

Now it is the turn of the Financial Standards Accounting Board (FASB) to set the rules. Abetted by the auditing profession, who will make sure that appraisers follow the new approaches to valuation, the SEC itself will insist on compliance. Effective in July 2005, every valuation that will be used in financial statements *must* comply with the new guidelines. About the only exceptions to the primacy of the FASB in the valuation field will be appraisals for litigation, gift and estate tax, and property tax, none of which directly affect published company financial statements.

But every business enterprise valuation, every allocation of purchase price, every valuation of corporate securities, every determination of intangible assets, and every impairment test *must* be prepared in accordance with the new guidelines.

The alternative is to have auditing firms, and by extension the SEC, reject the valuation. In short, appraisers either. Learn the new FASB approach, or seek employment elsewhere. It is that simple.

## The FASB's New Exposure Draft

At the end of June 2004 FASB issued an Exposure Draft (ED) with the seemingly simple title "Fair Value Measurements". While appraisers are both familiar with and comfortable with the concept of Fair Market Value (FMV), accountants for years have been using the term Fair Value (FV). Until now there has been some confusion as to whether FMV and FV were the same; if they differed just how they did differ? FASB has resolved this issue:

**"Fair Value is the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties" [¶ 4]**

While the words are somewhat different from the usual standard definition of FMV, the Board indicates that they intend their FV concept to be "an estimate of an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability". Further, they consciously have tried to conform their definition, and explanatory text, to the appraiser's standard definition of FMV.

There are several important concepts embedded in the Board's definition of FV:

- The estimate is determined by reference to a current hypothetical transaction between willing parties
- Willing parties are presumed to be marketplace participants [emphasis added] representing unrelated buyers and sellers that are (a) knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction, and (b) willing and able to transact in the same market (s)
- Fair Value presumes the absence of compulsion (duress)
- Accordingly the amount that forms the basis for the [FV] estimate is the price that would be observed in a transaction other than a forced transaction or distress sale
- The [FV] price shall be estimated without regard to an entity's intent to currently enter into such a transaction

## The Fair Value Hierarchy

Very early in their careers appraisers are taught the three approaches to valuation:

- Income Approach
- Cost Approach
- Market Approach

Wherever possible one is supposed to utilize two, or even all three, approaches. Value indications from

## The New Rules for Fair Value

each approach are then correlated by the appraiser, in the final analysis utilizing professional judgment. To an appraiser there is no one 'right' valuation approach. Depending on the purpose of the appraisal the preferred valuation approach will differ; e.g., for insurance purposes one would favor a cost approach while in valuing a closely held security or a leveraged lease one might prefer the income approach. In real estate appraisals land is almost always valued on the market approach. The valuation approach is determined *after* one understands the client's requirements.

Now, in its ED, the FASB has turned things upside down. The FASB explicitly puts primacy on the market approach and only if that does not work are appraisers even permitted to use the Cost or Income approach. In the ED there are three levels of valuation. Level 1, the highest, is based on the market approach where there is an active market and quoted prices are available for identical assets.

Level 2 is based on the same market(s) but applies when quoted prices for *identical assets* are not available; however, Level 2 can be used only when the price effect of the *difference* from the quoted price is available. "An observed price of securitized receivables can be used as a basis for estimating the fair value of unsecuritized receivables of the same type, but only if the price effect of the securitization is *objectively determinable* [emphasis added]".

Level 3 in the FASB's hierarchy, the lowest and least desirable, is to be

used "[only] if quoted prices for identical or similar assets or liabilities are not objectively determinable". In that situation, which is virtually 100% of the valuation situations faced by appraisers who specialize in business enterprise valuations, the valuation will be considered a Level 3 analysis. The Board does permit the use of valuation techniques, including the Income, Cost and Market approaches, in a Level 3 valuation, but with one important caveat.

### Marketplace Participants

In the Board explicitly states "Valuation techniques used for Level 3 estimates shall emphasize market inputs, including quoted prices generated by actual (observable) market transactions, adjusted as appropriate...a price might need to be adjusted for differences in the unit of

approach the valuer would use quoted prices for similar *used machines* [emphasis supplied] that are not installed (on the loading dock), adjusted for installation costs (to reflect prices for similar used machines that are installed)".

This requirement is totally consistent with the entire ED and with the Board's discomfort with so-called 'subjective' values, values that an auditor or another appraiser might have trouble replicating. There are two problems with this requirement:

- 1) It is totally at odds with the way appraisers have actually determined the value in-use for machinery and equipment (M&E) in purchase price allocations; and
- 2) There are going to be significant unintended

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account, condition, or location, or to reflect the appropriate valuation premise." Then in the ED provides an example of a purchase price allocation in a business combination.

Dealing with a machine that is installed and will continue in use, the ED states "in applying a market

consequences, consequences that companies will like and that auditors and the SEC may not like.

The above conclusions are premised on my assumption that historically we have determined value in-use on the

## The New Rules for Fair Value

basis of Cost of Reproduction New less depreciation (CRNLD) from all causes. Typically we have not attempted to price out an entire complement of M&E from the used equipment market. We test certain of the CRNLD prices to see that they approximate current used market conditions, but basically we start with the client's fixed asset records, "trend and bend" the original costs with indexes, and then apply depreciation based on observed condition.

Given vagaries in the availability and condition of assets in the used equipment markets for all types of industries, it is our professional belief that the FASB approach is going to lower the values assigned to M&E. The consequence is that a greater amount of the purchase price will be assigned to non-amortizable goodwill, and less to depreciable assets.

Some may argue that used equipment market prices, if one adds transportation and installation, will approximate CRNLD. Our experience suggests otherwise. New equipment prices, from original equipment suppliers, tend to move slowly and in conjunction with technological improvements. Used equipment prices rise and fall based on supply and demand. A modest surplus in the used market for a particular model milling machine, for example, may cause both auction prices and dealer quotes to be quite low. On balance, given the economics of used equipment dealers, with a proclivity to turn over the inventory as quickly as possible, yet with the knowledge that a particular machine may remain unsold for years, we believe that going

to a used equipment basis of pricing M&E is going to lower allocated values by anywhere between 15% and 40%.

A further point that should be made here, and a subject for a separate article, relates to the 'condition' of used equipment. How do you determine condition from a dealer's price list or auction results? One only has to go to the Sunday newspaper and look at used automobile ads to see that asked prices for the same model will differ by up to 30%; how do you as a prospective buyer evaluate those cars without looking at them? By the same token it is totally impractical for an appraiser to fly around the country trying to see the condition of all the types of used equipment that would make up the complement of a particular facility.

This analysis applies to discrete machinery and equipment. When one turns to valuing process equipment, e.g., a chemical plant, where do you get used equipment prices for piping and wiring? Such costs represent a substantial portion of the value of a process plant that is up and running. The actual costs for used piping are low. Making sure that the piping is laid out properly in the client's location, however, is not going to be captured by going to the market or market participants. So if we are valuing a process facility after the ED's approach is in place, we can demonstrate to an auditor, with accuracy to the third decimal place, the price per foot for used piping, which may be 10% of the plant's value. But how are we going to obtain

a "used market price" for the installation?

Now at this point it should be made clear that we, and all other appraisers, will be able to implement the FASB's new approach. The answers will differ from what we did before, and it is not clear that either one is 'right' or the other is 'wrong'. We can do it either way. But there is virtually no doubt that the Board's emphasis on so-called "market participants" is going to change the answer.

### Emphasis on Financial Instruments

As a generalization, auditors (and the FASB members and staff for the most part have an auditing background) are not comfortable with inventories and M&E. They are far more comfortable with financial instruments, where there are quoted prices, or prices in markets that can be approximated. It is interesting that the first two of the three "Levels" discussed in the ED apply *only* to financial instruments. Most of the discussion in the ED deals with blockage discounts, whether to use the bid or ask price of securities, portfolios, and so forth. There is zero discussion of Real Estate, inventories are explicitly excluded from the ED, and M&E gets little coverage.

Finally, our experience in purchase price allocations suggests that the biggest difficulties lie in the area of intangible assets, both in valuation and in setting lives. The FASB issued Concepts Statement 7 (Con 7) several years ago with the title "Using Cash Flow Information and Present Value in Accounting Measurements". The thrust of that Statement is "Expected Value", derived from subjective

## The New Rules for Fair Value

probabilities. Appraisers who have tried to apply Con 7 in real-life situations, particularly intangible assets, have had difficulty, and to do justice to that topic too would require a separate article. Suffice it to say, that appraisers will not find much help in the ED in determining the Fair Value of identifiable intangible assets.

### Valuing Liabilities

Finally, in this brief introduction to the brave new world of Fair Value for financial reporting, we have to look at the issue of valuing liabilities. Keep in mind that the very definition of FV, quoted at the beginning of this article, talks about assets and liabilities. The FASB is going to come out soon with a requirement that, in future allocations of purchase price, companies must place a value on both actual and contingent liabilities. So, for example, if there is a contingent payout based on future earnings of the target company, the estimated amount of the payout likely to be incurred must be determined and shown as a liability.

Similarly lawsuits, even those unlikely to be lost by the company, will have to be valued. If you were valuing a tobacco company today, how would you value the potential legal liability

for all the lawsuits faced by every company in the industry? Nonetheless, despite the difficulty, there is no question that the FASB is going down this path, and the current ED will be used by them as justification for adoption of the requirement to value all liabilities, using the ground rules set forth. Can it be done? Yes. Will the answers be useful to creditors and shareholders? Probably not. Will the FASB go ahead anyhow? Yes.

### Conclusion and Recommendation

The comment period for the ED will have expired on September 7, 2004. Based on our analysis of the ED, and the questions raised by the FASB, it is our belief that the Board will adopt this ED as a formal statement, making Fair Value Measurements an integral part of Generally Accepted Accounting Practices (GAAP). There will be few changes to the present ED made as a result of public comments and response. The focus on financial instruments, market participants, and liabilities will continue.

We, as appraisers, will find a lot more work than we have had before, at the expense of even more scrutiny of our

work by auditors and the SEC. In a forthcoming article we will discuss the impact of Sarbanes-Oxley on appraisers. This ED on Fair Value will only exacerbate the S-Ox changes to our relationship to clients, auditors and the SEC

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