

The Impact of Sarbanes-Oxley on Appraisers

By Alfred M. King



think that Sarbanes-Oxley is, in my judgment, working in many respects better than I had ever expected, and I think that the best way to

evaluate this is to consider the number of nonpublic companies that have embraced the principles of Sarbanes-Oxley."

In the October 2004 issues of *Consulting*, this was Arthur Levitt's response in an interview on this all-important act affecting appraisers and accountants. As the former Chairman of the SEC he had fought valiantly, but eventually unsuccessfully, to separate consulting services (including valuation) from public accounting firms. Sarbanes-Oxley however, accomplished what Levitt had been unable to do. The answer as to why can be summed up in one word: Enron.

If recent history had been written by the authors of the King James Version, it might have gone something like this:

- Loose valuation standards on derivatives begat Enron
- Enron begat WorldCom

- Enron and WorldCom begat Congressional hearings
- Congressional hearings begat Sarbanes-Oxley (S-Ox)
- Sarbanes-Oxley begat Public Companies Accounting Oversight Board (PCAOB)
- PCAOB begat close scrutiny of auditing firms
- Scrutiny of auditing firms begat tightening up of valuation standards

One often reads about 'unintended consequences' when laws and regulations are passed. In the case of the valuation industry, it appears that the consequences following Enron and WorldCom, closer scrutiny of our work, was intended by Congress; at a minimum close scrutiny of our work by auditors is in the spirit of the objectives set forth in the S-Ox Act.

The only place that valuation, *per se*, is mentioned in the actual language of the S-Ox act is to prevent auditing firms from performing valuation assignments for their audit clients. Nonetheless, the current increased scrutiny of our valuation work, if it prevents or even reduces the possibility of a recurrence of a future Enron, is unlikely to draw criticism from regulators. While we as appraisers can complain that our work is being overly scrutinized, and that ridiculous amounts of time are being spent in responding to auditor questions, our complaints are not going to be received graciously at either the PCAOB or the SEC.

PCAOB Mandate

The new kid on the block, PCAOB, is a direct consequence of S-Ox, because in fact the act mandated its formation. Congress felt that many of the horror cases in financial fraud and financial reporting were caused by auditing firms not doing their job. Whether auditing firms are able to find management fraud given current auditing techniques, is an open question. Yet outside observers ask that if auditing is not supposed to find fraud then what is it to accomplish? Put a different way, financial statement users, and hence Congress, feel that auditors have to do a much better job of finding fraud.

In turn, this has led to the auditing firms themselves now being audited by PCAOB. PCAOB auditors are going to the major firms and closely reviewing the working papers of a selected group of the firms' audit clients. The basic findings of PCAOB are being disclosed publicly, so there is a real possibility of embarrassing disclosures about audit performance.

This detailed review of audit firm working papers, in its turn, has led auditing firms to review carefully all valuations that affect a client's financial statements.

Technically, a company's financial statements are the responsibility of management, so if a company hires a valuation firm say to allocate a purchase price, the final values are

management's responsibility, not the appraiser's. In practice management can, and does, offload that responsibility by hiring an independent appraisal firm. In turn, the PCAOB auditors do not care *who* performed the appraisal, all they are interested in is *how* the auditing firm satisfied itself as to the validity of the answer.

PCAOB Skepticism About Valuation

The fact that PCAOB will be reviewing auditor working papers to see how they evaluated Fair Value (FV) information is reasonable. The fact that in turn auditors will review our FV determinations, even though painful at times, is probably not unreasonable. Excess scrutiny of what in the final analysis is a professional opinion may be frustrating, but will have to be accepted if we are to remain in business. What is potentially dangerous in all this is that the PCAOB, and for that matter the Federal Reserve System, simply does not trust appraisals or appraisers. In a recent speech Mr. Douglas Carmichael, the PCAOB Chief Auditor, said:

"to the extent accounting measures incorporate management's thoughts about the future-such as management's intent or forecasts-those thoughts cannot be verified because they also are not observable.

Consider the implications of this situation, and I mean by that, the lack of verifiability, for the increasing instances in which the

FASB specifies the use of fair value in accounting measurements. The FASB specifies that quoted market prices in active markets are the best evidence of fair value and should be used if available. If quoted market prices are not available, the best available information should be used. The estimate of fair value should consider prices for similar assets or liabilities and the results of valuation techniques.

Quoted market prices and prices for similar assets or similar liabilities are observable. Thus, when fair value is measured in this way, the measure is directly verifiable. Valuation techniques include internally developed models that make direct verification of the measurement impossible. The method can be verified, but the task of minimizing measurer bias is difficult at best. Those valuation techniques, according to the FASB, should use assumptions that market participants would use in their estimates. Doing so can raise very difficult issues when the terms of the transaction take it outside observable market conditions. Enron did this with its energy contracts and the auditor's judgments about fair value accomplished little to nothing in removing measurer bias.

When fair value cannot be measured by reference to matters that are directly observable, and if the measure represents little more than the measurer's state of mind, neither the measurement

nor the measurement method are verifiable. In those circumstances, the independent auditor has a scope limitation and should not express an unqualified opinion on financial statements that are materially affected by such a measurement. [Emphasis added] However, there is nothing specific or definitive in accounting or auditing standards to direct this result."

Taken at face value this will put auditors in an almost untenable position. Take, for example, In-Process Research and Development (IPR&D). When valuing this intangible asset, an appraiser essentially has to rely on management's opinion on the commercial possibilities of the new product/process, as well as the financial projections. Obviously there is no 'market' for most IPR&D that is directly measurable. The methodology for IPR&D was established by an AICPA task force, so an appraiser can demonstrate that the correct methodology was followed. But how do you determine that the chances of a successful completion of the project, much less the financial outcome itself, are anything other than management's opinion? Certainly an appraiser can have had experience in this field and can confirm that management's opinions are 'reasonable'. So also the auditor can apply his judgment as to the 'reasonableness' of the management opinion and the appraiser's evaluation of that opinion. But how do any of them (management, appraiser, and auditor) 'prove' this to a skeptical PCAOB auditor, especially one or two

years later when subsequent events may have disproved the contemporary assumptions, no matter how reasonable at the time?

The Federal Reserve has also weighed in on the subject of Fair Value.

In a September 28, 2004 speech Governor Susan Bies stated:

While historical cost accounting methods have well-developed auditing techniques, fair value accounting relies on key assumptions, modeling techniques and judgment. For example, modeling techniques are commonly used in valuing mortgage loan servicing assets. The present value of the estimated future net cash flows of servicing assets attempts to anticipate prepayments of mortgages due to changing interest rates, fees earned from late payments, cost to receive payments and remit funds to investors, costs to handle delinquent and charged-off loans and other factors. Changes in the assumptions used in the modeling approach for any instrument or product will change the resulting values. Further, the models used for financial statements look to what the market would expect these revenues and costs to be, rather than the firm's specific information. Since sales of servicing assets, especially for seasoned loans, is so irregular, it is often difficult to validate the model against actual values seen in the market.

Thus, auditing model-based accounting requires a high level of specialized knowledge. The auditor must fully understand how modeling or other sophisticated techniques are used to determine fair value, and whether the assumptions used in the models are appropriate, and that the data has integrity. Furthermore, "fair value" is not always clearly defined or easily determined for some products or instruments. Certainly, a non-complex instrument that is highly liquid with an observable market price is easier to value with more precision than a highly complex, illiquid instrument. Accountants are being asked to know more than just the proper classification of assets and liabilities, but also the appropriate way to value assets and liabilities.

Let me mention that the Federal Reserve supports a fair value-based measurement for assets and liabilities used in the business of short-term trading for profit, such as the trading account for banks. And we support enhanced disclosures of fair value-based information. However, we believe that the accounting industry should be very careful before moving toward a comprehensive fair value approach, where all assets and liabilities are recorded on the balance sheet at fair value and changes in fair value are recorded in earnings, whether or not realized.

In today's world, with the myriad of complex financial instruments

that exist and are constantly being created, developing verifiable and auditable fair value estimates is a major concern. The lack of observable market prices, differences in modeling assumptions, expectations of future events and market conditions, as well as customer behavior make the task of assigning appropriate valuations very difficult. And because fair value models are forward looking, the auditor has an additional challenge of determining the line between normal variability in expectations that surrounds any forecast and earnings manipulation.

To its credit, the Financial Accounting Standards Board (FASB) has recently issued an exposure draft on fair value measurement. The proposal was developed to provide a framework for fair value measurement objectives, and it is just the initial phase of a long-term fair value project. The initial phase is generally intended to apply to financial and nonfinancial assets and liabilities that are currently subject to fair value measurement and disclosure. It is not intended to expand the use of fair value measurements in financial statements at the present time.

In our view, the proposal is a good first step in enhancing fair value measurement guidance, but we believe additional guidance is warranted. Reliability issues should be addressed more comprehensively in the proposal. Most important, the FASB should

develop further guidance and conduct further research and testing to enhance the reliability of fair value measurements before the use of fair value is significantly expanded in the primary financial statements. Furthermore, we believe that the FASB should work with other organizations including the Public Company Accounting Oversight Board (PCAOB), American Institute of Certified Public Accountants (AICPA), and accounting firms to enable the development of robust guidance that ensures fair value estimates can be verified and audited.

Certainly the Fed is more concerned about financial instruments, and their valuation, than is the typical appraiser dealing with tangible and intangible assets. Banks, as lenders, are a primary user of financial statements, and bank lending is reviewed by the banking regulators including the Fed. Keep in mind that the S-Ox requirements on financial reporting, including certification by management, apply to banks, as well as 'ordinary' companies. So if bank credit analysts are uncomfortable with FV disclosures by their customers, or if bank regulators are uncomfortable with the banks' own analyses of FV information, then once again we as appraisers, and our valuation reports, are going to be scrutinized as never before. The fact that the Federal Reserve is now interested in, even involved with, Fair Value information simply adds one more caution flag.

Auditing Fair Value—Other Views

The PCAOB has a Standing Advisory Group, made up of investors and auditors. At a recent meeting, monitored by Financial Executives International, the following points were made:

- The PCAOB should work with SEC and FASB "on changes in auditing methods and audit reporting" relative to FV measurements
- The FASB Board member observer said they had had discussions with banking regulators about the difficulties of auditing 'intent'. This is because management intent can affect the premise of value, e.g., Value In-Use or Value In-Exchange
- Investor representative expressed concern about applying FV-based accounting that will result in financial statements that will simply be liquidation value.
- Another investor representative warned that "to the extent we put out FV measurements that cannot be verified, they are not going to be relevant, and could cause damage to the system.
- Finally, the investor pointed out that "we went down that route in the 1920s...."
- An auditor suggested that "there should be the same level of assurance on FV numbers as anything else, i.e., 'reasonable assurance', but there may be different levels of precision on these FV estimates, and perhaps ranges should be disclosed"
- A preparer commented that to the extent FV measurements are going to be involved in the FASB's new revenue recognition

project, it will be hard for Corporate Controllers to actually control

- Another preparer expressed concern about that potential variability of FV information

There are no shortages of ideas, caveats and suggestions regarding the increasing use of FV information in financial statements. By the same token there is little agreement among preparers, auditors, users and regulators. The one voice that has been very silent in these discussions is that of the appraisal community itself. What do we think should be done?

The FASB has an advisory group but few of the members are practicing appraisers; rather academics and security analysts make up a large portion of that group. Keep in mind that when it comes to the availability of additional information, security analysts always want more. For them, it is a free good, and even if they can not explain how they use FV information they would rather have it than not. Academics, by and large also like the idea of FV information because it gives them something to research. The 'publish or perish' syndrome pushes academics to write papers criticizing each other as well as preparers. The lack of FV information is held out as one of the causes for financial reporting scandals, such as Enron and WorldCom. "If only...." - and you fill in the blank. Unfortunately most of the 'research' performed by academics has little relevance for financial statement preparers or for appraisers, but that does not stop the criticism. Such academic criticism, in turn, is picked

up by FASB, SEC and PCAOB when they make their determinations on policy issues.

Where Are We Going? What Can We Do?

The following conclusions appear to follow from the above:

- The freewheeling valuations used by Enron to support their earnings momentum are history.
- Valuation reports, and the work of appraisers, will continue to be scrutinized closely by auditors. If anything this scrutiny, e.g., demands for 'support' for the assumptions inherent in the valuation process, will increase.
- Academics and financial statement users will demand increased Fair Value information. FV will continue to be an essential part of financial reporting, with 'rules' developed by the FASB, SEC, PCAOB, and Federal Reserve as to how we do our work.
- Appraisers will have to develop a degree of 'independence'. We will have to 'stand up' to clients who desire unsustainable answers, for example to avoid an impairment charge.
- At the end of the day, valuation will continue to be an art, not a science. If users demand FV information somebody's judgment will have to prevail. Nobody is better qualified to exercise this judgment than a qualified appraiser.

Alfred M. King is Vice Chairman of Marshall & Stevens. Formerly Chairman of Valuation Research Corporation, Mr. King has over 35 years experience in the valuation industry, helped start the Appraisal Industry Task Force, and is the author of a book and many articles on valuation subjects.