CHAPTER 1

What Is Fair Value?

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Most readers of this book have an intuitive understanding of the term *Fair Value*. For example, if your house were to be condemned by the local Department of Transportation to build a road through your backyard, you would want the state to pay you the Fair Value of your property.

You also have probably heard and used the term *Fair Market Value*. In common parlance, Fair Value (FV) and Fair Market Value (FMV) are used interchangeably; they represent what is considered reasonable by an outside observer if a buyer and seller are going to consummate a transaction. The notion of fairness permeates discussions about value, and the assumption is made that both parties have essentially equal knowledge about the property in question, and neither party is contemplating a forced sale or purchase.

The Fair Value of your home or your car is, in practice, a far more complex concept than may appear at first glance. Take your home: Is the current FV based on what it would cost to rebuild if it burned down (insurable value or replacement cost)? Or is it what you want your local property tax assessor to base next year's property taxes on? Or, finally, is it what you could receive if you called a broker and put the house on the market?

Minimum thought will rapidly lead to the conclusion that those are actually three *different* values. Which is correct? The truth is that all three answers are correct, but each is valid *only for the purpose for which it was developed*. You would not want to pay real estate taxes on the cost to rebuild your home, and you might not want to sell your home solely on the basis of its assessed value for taxes.

Transactions are based on current values. Transactions are never based on what you, the owner, might have paid for the asset several years ago. The real estate assessor does not care about your original cost, and neither does the prospective buyer of your house if you have to move. The insurance company might be interested in what the house cost to build if it were new, but your purchase price from the original owner tells the insurance company nothing about what a new house would cost if your existing structure burned down.

When decisions about property are concerned, the *only* relevant information is its current value today. Every decision *you* make is based on *your* evaluation about today's value to you. Somebody else's cost is irrelevant.

By the same token, if no transaction involving your property is contemplated, it is highly unlikely that you need to refine your understanding of the true FMV.

Generally Accepted Accounting Principles (GAAP) is the language of business. In today's environment, the GAAP rules are promulgated by the Financial Accounting Standards Board (FASB) under the auspices of the Securities and Exchange Commission (SEC). GAAP rules are enforced on their clients (companies) by auditing firms; in turn, the work of the auditors is reviewed by the SEC and Public Company Accounting Oversight Board (PCAOB).

GAAP is pervasive in the business world. Virtually every set of financial statements sent to people outside a firm (recipients such as bankers, suppliers, and investors) *must* be prepared following GAAP rules. Unless prepared in accordance with GAAP, auditors cannot and will not sign off on financial statements, because their certification states that the financials were in fact prepared in accordance with GAAP.

How does this discussion of GAAP tie into earlier comments about Fair Value? In fact, it ties in directly because GAAP is undergoing a transformation at the hands of the FASB. Right or wrong, the FASB is starting to require GAAP to be prepared using Fair Value concepts.

In the remainder of this book, you will learn what these new rules are, what impact they will have on both preparers and users of financial statements, and what you as an executive can do about this radical change in financial reporting.

FASB IS PUSHING FAIR VALUE

The author has debated over the past ten years with many Board members and staff of the FASB about the use of Fair Values in financial reporting. To avoid any thought that there is a conflict of interest, I am unalterably opposed to many of the actual and prospective uses of Fair Values, as defined by the FASB. Will such requirements help my business? Undoubtedly, the answer is yes. All appraisers will gain from the use of FV information—just as auditors gained following mandatory audit requirements in the Securities Acts of 1933 and 1934.

But the fact that something will help my wallet and put food on my table does not make it right. This book is not the venue for me to carry on my crusade against Fair Value reporting. I do this in many other forums.

The FASB is publicly committed to the increasing use of Fair Value in financial reporting. Actions sometimes speak louder than words, and we discuss many of the new FV rules recently promulgated by the FASB. But the situation is actually far direr. The FASB in the United States and the International Accounting Standards Board (IASB) in Europe are publicly committed to extending FV concepts in financial reporting.

In fact the only reason the two Boards have not yet mandated full FV reporting is that they would face a massive revolt by their constituents, that is, preparers, auditors, and users.

If preparers, auditors, and users are *not* clamoring for full FV financial reports, then why are the two Boards inexorably marching down that path? There are two separate, and essentially unrelated, answers. One relates to the Enron experience and the other is based on pure "accounting theory."

FINANCIAL INSTRUMENTS AND THE LEGACY OF ENRON

There were many causes of the Enron debacle, and they included auditor mistakes, fraud by management, banks enabling improper financing, and improper valuation of financial instruments. In a nutshell, Enron management, as just one example, assumed that they

could develop a product using the Internet to download information and movies to users. They created a financial instrument that assumed future revenues would be generated from this as yet non-existent service. The financial instrument was then valued, by Enron—with concurrence from their audit firm—on the basis of the "present value" of the future cash flows expected to be received. The calculations, and the valuation, were all internal to Enron.

Using their own calculations, Enron effectively created *income*, which they then picked up on their income statement, with the offset as an *asset* on the Balance Sheet representing the current FV of the derivative. Of course, when Enron began to deteriorate or implode, this *asset* turned out to have no value because their Internet download never got off the ground.

Following the Enron collapse, some observers of accounting came to the conclusion that one of the factors enabling Enron to "cook the books" was its ability to value its own financial instrument. The solution, to the rule setters at the FASB, appeared simple.

Instead of allowing a company to value its own instruments on the basis of its own calculations, under the new approach the instrument would have to be valued by what outside buyers would pay for it. In other words, the market itself would be the basis of valuation. Going to the specific Enron *asset*, it is highly doubtful that an independent third party, a dealer in financial instruments, would pay very much for a highly speculative stream of *income* that extended out some 20 or more years. Thus, instead of permitting Enron to use its own assumptions, the value for financial reporting would be based on *real-world* transactions. In short, were the new rule to have been in effect then, the Enron derivatives games could not have been played.

To counter the abuse by Enron, the FASB, with encouragement from the SEC, instituted new tightened rules. The stated purpose of the new rules—and it is hard to argue against the objective—was to make sure that all Fair Values that appeared on a company's Balance Sheet would be derived from the market itself, not self-interested internal assumptions. Further, for the types of financial instruments that Enron created, there were market makers who either already dealt with that type of product or would quickly set themselves up to make a market. The market for financial instruments has been growing at a rapid rate over the past ten years, and the number of

new instruments is truly endless. By making one rule for all financial instruments the FASB once and for all appeared to put a stop to this particular area of "creative accounting."

THEORETICAL MERITS OF FAIR VALUE ACCOUNTING

Accounting theoreticians have been proposing one form or another of accounting based on value for almost 40 years. The first big push came in the late 1970s when inflation rates in excess of 10% and even 15% appeared in the daily headlines. Compounding 15% inflation for several years will destroy the usefulness of accounting reports based solely on the "original cost" of assets acquired ten or more years ago. Depreciation expense based on original cost will not be sufficient to replace old assets when they must be replaced.

Certainly, the experience of countries with persistent inflations, such as Brazil, suggests that some form of adjustment must be made in order to make current financial statements relevant. Inflation is no more or less than a reduction in the value of the unit of currency. Without some form of adjustment, therefore, a dollar spent ten years ago appears to be the same as a dollar spent this year. Yet, in a period of inflation, today's dollar may be worth only 30¢ relative to $1 ten years ago. (This is without considering the time value of money, which also makes comparisons between today and previous periods difficult.) Inflation destroys accounting comparability.

So, one argument in favor of value accounting deals with trying to overcome the impact of inflation, the depreciation in the value of the unit of currency. But there is a second, and equally compelling, argument. Even in the total absence of inflation, some prices go up, and others go down. This may be the result of productivity, material shortages, new products, and many other causes, including technology.

But if current values differ from those present when the asset was acquired—either up or down—then current financial statements do not reflect the *real* value of the assets, with real value defined as what it would cost today to acquire the asset *or* what the asset could be sold for to a third party.

Under that approach, wanting financial statements to show current values, today's traditional financial reporting model, based as it

is on actual historical prices paid, does not reflect economic reality. Proponents of having financial statements prepared on the basis of current values argue that such information is useful to readers of the statements, and that outdated historical costs are irrelevant for making decisions today. In short, the focus is on the *users* of financial statements and what it is assumed they want or need.

Taking this argument one stage farther, these accounting theoreticians believe that primacy among financial statements should be placed on the Balance Sheet, with the Income Statement merely reflecting the changes between the opening and closing Balance Sheets.

Most readers of this book, however, were brought up on the belief that the Income Statement should represent what management has done with the shareholders' assets. The profit-and-loss (P&L) statement should be viewed as a report card on management performance. This school of thought asserts that a theoretical current value of an asset that is not going to be sold or disposed of is of little use in evaluating management performance. Because it is difficult to make the Balance Sheet and Income Statement "articulate" if current values are introduced, most executives are willing to let the Balance Sheet be a residual, as long as the Income Statement reflects current performance.

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.

So, while the true merits of current value accounting can continue to be debated, it appears that this particular train has already pulled out of the station, leaving behind advocates of historical cost as well as the primacy of the Income Statement.

FAIR VALUE IS THE NEW PARADIGM

The FASB, with total support from the SEC, has determined that Fair Value is better information, and that the Balance Sheet has to be correct. Based on the Enron debacle, the Board believes that Fair

Value for financial instruments is the proper approach. In turn, these are to be valued by looking at what some outside market participant would actually pay to buy the instrument(s).

There are two key concepts here that must be clearly articulated. First, the Board believes that current or Fair Value is to be determined by what they call an *exit price*, and most observers would define this as what something could be sold for. Second, the relevant market for estimating selling prices has to be determined by looking to the perhaps somewhat theoretical concept of *market participants*.

Further, the Board's emphasis on the importance of the Balance Sheet, and the relegation of the Income Statement to third-class status, has profound implications. In practice, if the Board goes all the way in implementing its approach, changes in the Fair Value of assets will be considered income (or loss) of the period. Thus, simply holding a financial instrument that goes up or down $1 million in a year because of changes in interest rates will have the *same* P&L impact as does selling $20 million of goods and services with a 5% after-tax margin. Management, as well as many investors, feels that product or service revenues and costs are pretty important. Except for dealers in securities, changes in interest rates are irrelevant in looking at the performance of most manufacturing or service businesses.

The purpose of this chapter is only to discuss what is, and what management can do about it. While it may be satisfying to argue that the FASB is wrong, it really does not help run a business more effectively and efficiently. So from here on, this book accepts the Board's decisions, but does reserve the right to point out the possible pitfalls for management in following the new FV requirements. Given the FASB's requirements, we show you how to minimize the adverse consequences.

How Reliable Are Fair Values?

It was stated earlier that the FASB was concerned about Enron and several other horror cases in accounting, such as WorldCom and HealthSouth. In response, they feel that adoption of FV financial reporting will preclude management from developing and reporting their own values and consequently inflating reported income. Implicit in this approach is the assumption that Enron, or anyone else for that matter, can develop the true Fair Value of an asset. A direct

corollary, then, is that there is one, and only one, Fair Value for any asset.

After all, if Enron has an Internet derivative, one can determine the Fair Value by going to dealers in this asset. Among dealers, at any point in time, there may be very slight differences in their individual bid and asked prices. But, in the larger scheme of things, financial markets are very efficient. Even small price differentials are quickly erased by arbitrageurs. Consequently, determining the Fair Value of a financial instrument only requires making one or two phone calls, if the price is not actually quoted in today's *Wall Street Journal*. For practical purposes, any minor discrepancies among dealers can simply be disregarded.

Implicit in this approach to developing FV information is the assumption that markets are efficient, that price differentials disappear quickly. For financial instruments such an assumption is probably correct.

However, for financial executives in manufacturing, distribution, and service businesses, as contrasted with financial institutions, the markets that they have to look to for price quotes are *not* efficient. There is very little arbitrage available when it comes to determining the Fair Value of a 40-story office building. Such assets are only rarely traded. When they do trade, they are essentially one-off transactions because no two office buildings are alike. Just because the building next door sold two years ago for $175 per square foot does not mean that your building today would sell for $175, $200, or $150. There is no way to determine the Fair Value today of an office building short of either putting it on the market and selling it, or obtaining an appraisal from a valuation specialist.

From just this one simple example it is easy to see how trying to determine the Fair Value for financial reporting opens up several difficult areas, and many of these are themselves controversial. Suppose the building owner had just obtained an appraisal report that had been given to a bank to support using the real estate as collateral for a loan. Is the amount on that appraisal report, developed for financing, valid for financial reporting? Using the new FASB criteria, could the building be *sold* for that amount? Maybe not, because the financing appraisal might well have assumed just continuing with existing tenants and existing use. A buyer might want to redevelop part of the building for retail stores, which would change the value.

Observation: The new FV rules actually provide very substantial room for potential manipulation of reported financial results. Earnings can be, and we predict will be, managed through application of the current FV requirements.

Further, the FASB insists that the value be developed based on what market participants would pay. Who are the market participants for major office buildings? There are a number of real estate investment trusts (REITs) that specialize in office properties, and many institutional investors occasionally invest in real estate. But at any one point in time, trying to identify these theoretical buyers is far from a trivial exercise.

The bottom line is that the FASB wrote the FV rules with financial instruments in mind. Trying to apply these somewhat specialized rules to the great variety of tangible and intangible assets is causing, and will continue to cause, great troubles for businessmen, their auditors, their investors, and those of us in the valuation profession that have to try and develop this information on a supportable and auditable basis. No one wants a replay of Enron, but the new rules are going to cause a new series of problems, as will be discussed throughout the book.

Relevance of Fair Value

The FASB has two separate touchstones for financial reporting. The first is *relevance* and the second is *reliability*. Massive debates have hinged on which of these two is more important. Some argue, "What good is relevant information if it is not reliable?" The opposition counters by asking what good is reliable information if it is not relevant.

Reliability, while not identical with auditability, is usually taken to mean that if several independent observers had the same fact pattern, they would come out with very similar answers. Thus, if most accountants would treat the same fact pattern the same way, the financial information could be considered reliable. An example would be the recorded cost for a 1,000-ton press; most accountants would sum up the invoice price, inbound freight, installation, and

Observation: The same asset can have several different Fair Values, depending on the purpose for which the value is being developed. Put a different way, there is no such thing as "the" Fair Value of any asset. Multiple values are not only possible but often exist simultaneously. Any time the term *Fair Value* is used, the purpose and definition must be clearly stated, or major mistakes can be made.

setup. Cost accountants could argue whether some small amount of debugging should be capitalized, and practice might differ on this one factor; in any event, almost all accountants would agree within 1% or less as to the cost of the press. An auditor could satisfy herself by going to the paid invoices in the accounts payable department and comparing the amounts to the original capital expenditure request and to the respective purchase orders. In short, the cost of the press would be highly reliable by almost any standard.

When it comes to relevance, however, many critics of today's accounting, including many at the IASB and the FASB, as well as leading academics, argue that while the cost of the press is certainly reliable, it may not be relevant for today's decisions. Particularly if the press was acquired several years ago, and a new press would cost 20% to 30% more today, they believe that a more relevant piece of information for readers of the financial statements would be today's Fair Value of the press.

Of course, those same critics disagree among themselves as to whether the most relevant information is (1) what the item would sell for today in its used condition, (2) what a new press would cost to acquire, or (3) whether the cost new should or should not be adjusted for condition and location of the old press. These are in practice three quite widely dispersed amounts. So those who argue for relevance still have a burden of proving why *their* definition of relevance is better than some other definition.

The relevant Fair Value may not be totally reliable, because valuation is not an exact science. And a reliable determination of original cost may be highly reliable but not necessarily as relevant as Fair Value.

How Exact Can the Determination of Fair Value Be?

There are two questions every valuation specialist is asked prior to his engagement by a client:

1. "How often have you appraised assets in my industry?"
2. "How accurate will your answers be?"

The first question can be answered in one of two ways. If he has had prior experience valuing companies in that industry he very quickly brings out a list of prior engagements and points with pride to his undoubted experience. If, however, he has not happened to have appraised that *exact* industry, then he answers—with total conviction because it is true—that "it really makes very little difference what industry an experienced appraiser is working in because the valuation principles are always the same." In Chapter 11 we discuss briefly, from the perspective of a company, how to engage a valuation specialist and how the company should manage the work effort.

The second most frequent question deals with the accuracy and/or supportability of a specific valuation assignment. For many years, appraisers have used as a rule of thumb that if two separate appraisers are given the same assignment, for the same purpose, they will most likely come out within 10% of each other. Put a different way, we really develop a range of values, and within that range probably no one amount is better than another.

Most readers of this book will probably never have examined an actual valuation report in detail. Go to the Appendix to see an actual complete report sent to a client, disguised to protect confidentiality. Note that while this represents a real client situation, both the name of the company and the financial information have been disguised.

Reading the report you see that our firm, Marshall & Stevens, came to a very specific value as of the valuation date. The truth, however, is that there is probably a false sense of precision in most valuation reports. As mentioned earlier, we probably can only get within approximately 10% of the real value. But the report itself states a specific value, often down to the dollar.

The reason for *not* providing clients with a range is that many valuation reports are used for financial reporting, and accountants

cannot book a range of values; they must prepare a journal voucher with a single point number in order to balance the debits and credits. Consequently, valuation specialists show point estimates in the report. The true underlying Fair Value, however, is actually a range. In the absence of any other information, most appraisers would choose the midpoint of the range. They can, and sometimes do, choose a value at either the upper or lower range of values.

For example, if a client is borrowing money from a bank on a mortgage, the lender may want a loan-to-value amount of 80%. If the borrower is seeking a loan of $800,000, that means the client desires that the real estate appraisal comes out at or above $1 million. If the range of values we develop is between $925,000 and $1,050,000, we probably would not report the value as $987,500, which is the arithmetic midpoint. Rather, we would say in the text that there is always a range, but our best single point estimate is $1 million. The fact is that no appraisal is ever going to be accurate to within 2%, so rounding up from $987,500 to $1 million seems appropriate. The bank will not be hurt, and the borrower can get his loan without having to ask the bank's loan committee to make an exception to their 80% loan-to-value guideline.

Many clients really "push" the valuation specialist to arrive at some predetermined answer. For tax-related valuations, clients usually want the lowest supportable amounts, while for borrowing and sales of assets, clients usually want the highest supportable values.

Because of the absence of a "bright line" in most valuations, and the ability to arrive at a supportable answer within a somewhat narrow range, clients do in practice urge the appraiser to go as far as he can go to come up with an acceptable answer that meets the client's business needs. Not every appraiser is able to stand up to such client pressure. This is commonly recognized by many parts of the business community in referring to the MAI professional designation for real estate appraisers (*M*ember of the *A*ppraisal *I*nstitute) as "Made as Instructed." Appraisers hear this all the time, but only in very rare situations has the author seen actual reports that were unduly influenced by client demands. However, it does happen, and the writer has been an expert witness in several cases where the other side's valuation report just did not correlate with the real economics of the situation.

DEAL EXPENSES

This chapter has dealt with several subjects concerning the FASB's push to using value information in financial reports. In September 2006, the Board issued its Statement of Financial Accounting Standards (SFAS) 157, dealing with the definition of Fair Value, and providing guidelines for the determination of Fair Value. Contrary to the opinion of some commentators, SFAS 157 did not call for the further use of FV in financial reports. What it did say was that if you were required to develop the FV of an asset or a liability, the Standard told you how to do it. Consequently, SFAS 157 has become the new "bible" for appraisers.

As mentioned earlier, two of the basic principles were:

1. Values were to be derived on the assumption that the asset were to be sold (i.e., how much cash could be realized).
2. The estimate of that sales value was to be determined based on assumptions as to what market participants would pay for the asset.

These definitions are somewhat different from what appraisers have used in the past, where the term *Fair Market Value* was pretty clearly defined by the courts, the Internal Revenue Service (IRS), and general business practice. The new definition of FV has some significant ramifications, and one that will affect many readers directly is the legal and accounting expenditures for a business combination. (The FASB prefers the term *business combination*, whereas common parlance often uses the term *merger and acquisition* [M&A] transaction.) This will be discussed in detail in Chapter 4.

Under previous practice, when a buyer consummated a merger, there were usually major out-of-pocket expenditures for investment banking, accounting, legal, printing, proxy, and (very small) appraisal costs. These costs were considered part of the deal, and were capitalized as part of the transaction, along with cash paid to the sellers and stock issued to the sellers. Inasmuch as these costs can easily amount to millions of dollars, and were incurred only to get the deal done, capitalization seemed to make good sense. In fact, without those expenditures, the deal would not have been consummated.

The FASB's new definition of Fair Value, however, precludes capitalization of deal-related expenses. Now they must be expensed

as incurred. This outcome may not have been widely recognized because SFAS 157 becomes effective in 2009. But, regardless of when it becomes effective, the outcome is the same. Deal-related expenses are not considered part of FV.

Now you can argue with the FASB that capitalization of deal-related costs is virtually identical to the capitalization of inbound freight and installation for a piece of capital equipment. At least so far, the Board is not mandating expensing of inbound freight and installation—although some rumblings even here have been heard.

The logic for capitalization of freight and installation costs is that from the perspective of the buyer, the user of the asset, without such expenditures one only has a very expensive paperweight. The costs are absolutely necessary for the machine to work and produce its assigned output. So for the past 50 or more years, capitalization of freight and installation was not even considered as a matter of judgment. First-year accounting students learned the rules and that was it.

Now the FASB says, "Wait a minute. The M&A-related deal costs (investment banking, legal, audit, etc.) are *not* part of the assets acquired! If you value the assets acquired in accordance with the new definition (exit price and market participants), another buyer would not pay you for your deal expenses. They do not add intrinsically to the acquired assets from the M&A transaction. The fact that they were necessary for you to get the deal done is irrelevant to the new buyer." Hence, the Board says you cannot capitalize deal-related costs and must expense them as incurred.

The Board's new rules on deal-related expenses are totally logical *internally* and follow directly from the FASB's own new definition of Fair Value. The decision, however, just does not make sense to the buyer who *had* to incur the costs to conclude the deal process. "No expenses, no deal" is how most business executives view this issue. No matter what you think or believe, deal-related expenses are going to be expensed as incurred.

It is outside the scope of this book to argue with the FASB's rules on Fair Value. It will become abundantly clear that we feel there are major issues. But the nature of due process—and the FASB does indeed follow due process—is that once a decision is reached, you should follow it. Perhaps you can try to modify the application of the new rules, or if the new rules ultimately turn out not to be

operational you can get the FASB to change their mind. Until then, all we can do is try to understand the rules and apply them as effectively and as efficiently as possible.

This brief discussion of the expensing of deal-related costs is a good example of the major changes to be effected by the new Fair Value rules.

MANAGING EARNINGS: THE POTENTIAL FOR MANIPULATION

Further adoption of FV accounting is being pushed by academics, some security analysts, and the FASB members and staff. There is at least one thing holding back the rush, however. The determination of FV is inherently imprecise. Values can be determined only within a range of perhaps 5% to 10%. This means that two equally competent appraisers, given the same assignment and the same assumptions as to outlook and competition, should come within 10% of each other. They will not arrive at identical answers.

Reasons for disparities among appraisers can arrive from different economic and political outlooks (can anyone agree on what the stock market is going to do over the next six months, much less the next six years?). Which party will control Congress and the White House after the next election? Is the United States going to become more, or less, competitive relative to China and many third-world countries? The problems with foretelling the future will never be solved, yet every valuation *must* make some assumptions about the future.

The real wonder is that two valuation specialists can come within even 10%. Valuation is not the same as calculation of a lapse schedule on future depreciation. Two accountants, told to forecast depreciation expense on a new building and to use accelerated depreciation for book and taxes, should come out with the same answer. Two appraisers asked to determine the FV of the same building will not have the same answer. They may arrive at answers that are reasonably close, but they won't be identical.

The real issue is that valuation requires professional judgment. Appraisers may require ten or more years before they are truly competent to value most types of financial assets. (Real estate, machinery, and equipment appraisers are two subspecialties within

valuation.) But regardless of the length of experience and the quality of an appraiser's judgment, the fact remains that every valuation assignment requires professional judgment. Fair Values do not come out of a "black box" or a computer.

Every single appraisal report has one or more areas within the analysis where the valuation specialist has to make a choice based on judgment. And that judgment call cannot be audited. If a physician feels your belly and says, "I think you have appendicitis, and we should operate right away," he is exercising professional judgment. You can get a second opinion, but at some point you have to trust someone. And, occasionally, a physician will be wrong and you do not have appendicitis. Can the first physician's judgment call be audited? No. Based on seeing many similar cases, and comparing your belly to previous cases, he comes to a conclusion and expresses his opinion.

Now some readers may be surprised to hear that appraisers and physicians have very much in common. They do, in relation to the application of both judgment and experience being applied to a specific case.

Getting back to the heading for this section, how can Fair Values be manipulated? We disregard incompetence on the one side, and deliberate cheating on the other. (Remember the savings-and-loan [S&L] crisis of the early 1990s where fictitious valuations were prepared by "appraisers" who really did engage in fraud.) Recall that the professional designation for qualified real estate appraisers is MAI, which stands for Member of the Appraisal Institute. Unfortunately, as noted, many wags in industry refer to the MAI designation as standing for "Made as Instructed."

As with many witticisms, there is a kernel of truth here, and that is exactly what we referred to in terms of manipulation of Fair Value. It is a dirty little secret of valuation practice that clients often tell appraisers how they would like the report to come out. A borrower on a new building needs an FMV determination in excess of X, in order to obtain a loan. A probate attorney wants a block of stock valued at an amount less than Y in order to minimize estate taxes. And so forth. In practice, approximately 90% or more of clients know, in advance, what they would like the answer to be. This desire for a specific result sometimes is communicated to the valuation specialist, in a more or less direct form.

Most appraisers are aware of their client's wishes but can help only within a fairly narrow range, essentially the ± 10% that was mentioned earlier. But within that range, appraisers do have discretion. It would be unrealistic to assume that any professional is going to deliberately choose an answer at one end or the other within the range that will make the client most unhappy. Physicians want patients to return. Attorneys succeed through repeat business from a group of loyal clients. Auditors expect to work for the same company for many years as long as they provide good service. So, common sense suggests that appraisers, too, will try to provide a service to their client that encourages further business.

The question boils down now to the following: If appraisers have a narrow range, and within that range no point answer is better than another, then does coming up with a final Fair Value near one end of the range or the other represent "manipulation"? In one sense it does, because if the appraiser had no idea what the client was looking for, the odds are that he would have chosen something close to the middle of the range. However, as long as the final point estimate is supportable, and is within the range of acceptable answers, there is no manipulation.

The problem ultimately boils down to (1) inherently there is a lack of precision in valuation; and (2) clients have to have a point answer for recording in the books of account. While presenting a range would totally eliminate manipulation, who should choose the single point estimate within that range? Should it be the client, or should it be the appraiser? We vote for the appraiser, who, at the end of the day, has to be totally comfortable with his own professional judgments and has to be prepared to support them in a court of law, against an adverse party, or with the SEC.

Essentially, what one person is going to look at and call manipulation to achieve a predetermined answer, another person will say that trying to turn what is really a range into a single point answer simply is trying to square the circle and cannot be done without the exercise of judgment.

In terms of earnings management, management of a company is paid to produce certain economic results. Ideally, those results come from operations and not from earnings management of accounting results. But if you have a chance to put your best foot forward, within the rules of the game, why shouldn't you try to present a favorable

picture. As Lord John Maynard Keynes once said, "In the long run we are all dead," and many accounting textbooks equally proclaim that "In the long run accounting treatment has no impact of real cash flows." The problem is that, unfortunately, financial reporting deals with the short run, and the imprecision inherent in accounting and valuation simply cannot be overcome if companies must report quarterly and show a bottom line that is a single number. In short, all accounting presents a false sense of precision, and valuation only makes it worse.

The moral here has to be this:

> *Do not believe that just because an appraisal shows a value to the nearest dollar, or thousand dollars, that the* real *answer is exactly what is shown. Any time Fair Values enter into the bottom line the real answer is in a range, not the single point value presented.*