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When is the Market Wrong?

by Michael J. Mard, CPA/ABV, ASA

The market is wrong for fair value measurement for financial reporting when it's crazy, irrational, and inefficient. Today's "inactive market," so popular in the press, is nothing but an unbalanced market with sellers exceeding buyers. Equally inefficient is a hyper-active market with buyers exceeding sellers.

An efficient market means the market pricing is not biased; it is reflecting all information rationally such that excess profits (or losses) cannot be made. It's efficient, balanced. Fair value determinations under Financial Accounting Statement 157 (FAS 157), especially quoted prices (Level 1), should be made only based on active or efficient market inputs so as to avoid bias. Otherwise, the inputs would be apples and oranges when compared with management inputs (Level 3), which assume efficient (active) market inputs. Fair value requires orderly transaction inputs regardless of whether those inputs come from Level 1, 2 or 3 type assets. Up to now, however, there was no guidance for a company or auditor to deviate from raw market inputs even if the market was clearly inactive.

The Financial Accounting Standards Board (FASB) recently issued FASB Staff Position (FSP) 157-4 titled: "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly." The FSP essentially calls for a process to determine whether a market is active or a transaction is distressed.

First, a preparer of a company's financial statements should analyze factors that indicate a market may not be active. After evaluating all factors and considering the significance and relevance of each factor, the reporting entity shall use its judgment in determining whether the market is active. If the reporting entity concludes that the market for the asset is not active, then the transactions or quoted prices available may be distorted and not indicative of fair value. As such the reporting entity must develop further analysis and may determine a significant adjustment is necessary to the transaction or quoted price. Such analysis may include whether there was sufficient time before the measurement date to allow for usual and customary marketing activities for the asset and/or whether there were multiple bidders for the asset.

In order to determine if a transaction is orderly or not, a reporting entity must consider if the weight of the evidence indicates the transaction is orderly, and if so, consider that transaction price when

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Investment Fraud: What Investors Should Look For

by Michael A. Crain, CPA/ABV, ASA, CFA, CFE

The stories of recent investment frauds like Bernie Madoff and Sir Allen Stanford have been described extensively in the media. We ask yet again: how could these frauds have possibly happened? Hindsight, of course, is 20-20 and details that we know seem so obvious now that we believe the schemes should have been detected by someone much earlier. The 'someone' is often attributed to regulators, investment advisors, auditors, and so forth. Rarely are they seriously attributed to investors themselves– even the sophisticated ones. Of course, hindsight allows us to easily see the signals of wrongdoing, but–in daily action–there are often too many things to watch and, thus, problems often go unnoticed because of 'noise.' Still, investors (and others) can learn–or be reminded of–investment schemes where patterns seem to recur. Simply put, the details of each fraud change but basic concepts are often the same. In this article, we discuss some fundamental ideas that may be used to detect some investment frauds.

People either fail to realize or forget the basic idea that risk and return are necessarily related when it comes to investing. The markets work this way–most of the time. For instance, we observe that certificates of deposit and Treasury investments pay low interest rates. This phenomenon occurs for a reason: these sorts of investments have little risk. Conversely, investments in small-cap stocks provide higher returns over the long run because they have more risk. Even though the risk-return relationship seems elementary, investors still overlook it when making investment decisions. Too often they make decisions based on returns without fully considering the risks. The colloquialism 'if it is too good to be true, it probably is' is still a remarkable piece of wisdom today but is often neglected. Perhaps the reason is human weakness or–as some claim– greed makes people blind. Regardless of the reasons for this behavior, people should remember that basic finance theory says riskier investments generally provide higher returns over the long run. Next, this corollary follows: if an investment's returns are regularly high, you have likely taken on greater risk. This last statement is often where people are blinded, which can lead to investment fraud. In these sorts of cases, people pay for an investment, receive returns that are high or steady or both, but they fail to realize that they have taken on some form of larger risk.

In the case of the Madoff Ponzi scheme, Madoff gave investors information that said they were earning steady returns even in a volatile stock market. His claim seems like a case of something too good to be true. Indeed, it was. But Madoff offered a complex story of how he managed to accomplish it (i.e., a split-strike conversion strategy) that few probably understood. As it turns out, Madoff never even used this strategy nor did he actually provide investors with a steady stream of returns. Instead, he gave his investors the illusion that he could give them regular returns even as the stock market fluctuated. But people should have realized this phenomenon could not possibly be true– at least over the long-term. No fund manager is that skilled or that lucky.

In another recent scheme, Allen Stanford's bank in Antigua sold billions of dollars of high-yielding certificates of deposit to investors. These CDs were

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estimating fair value or market risk premiums, and if not, must place less weight on that transaction price. While a reporting entity need not undertake all possible efforts, it also can't ignore information that is available without undue cost and effort.

The very definition of Fair Value in the original statement, FAS 157, requires "an orderly transaction." There is nothing new here. But don't tell Steve Forbes that…or Congress. Both are on a rant complaining that "mark-to-market accounting" is the primary cause of the recent economic meltdown. As Forbes said recently (interview March 23, NBC, *Morning Joe*) "Mark to market is like selling your house in one day." No, Steve, mark to market, or more precisely fair value, requires an orderly transaction presumably in an orderly market. Could it be your own wealthy portfolio has taken a beating in the recent economic turndown? Welcome to the club.

The reality is the standard setters, like FASB, can only set the standards. Others, principally the SEC, must enforce them. The newly appointed Chairman of the SEC, Mary Schapiro, recently announced additional funding to bolster the enforcement division of the SEC. It's all a simple formula, really. The FASB establishes the standards, the preparers (companies) implement them into financial statements and the SEC and others are the cops to make sure the laws are followed.

Fair value, including mark to market, requires orderly transactions. Sometimes the market is wrong, not orderly, like now. In these instances, preparers, auditors, valuators, regulators and users of financial statements all have a responsibility to use judgment…the judgment to present reasonable estimates based on an efficient, balanced and stable market. To do otherwise creates a bias that harms everyone. ~~~

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described as relatively safe even though they often paid interest rates more than twice the going rates offered by other banks. But this activity does not seem to fit the risk-reward relationship discussed earlier. If the risks were so low, why did Stanford pay such high returns? In a legitimate operation, there would be no reason– and no way to sustain that business model. As we now know, that business activity was indeed not sustainable.

In addition to the conceptual idea of risk-reward relationships, facts–or red flags–that were widely known were essentially ignored by many people-–including investors. For instance, the financial statements of Madoff's firm were audited by a two-person accounting firm. Common sense should produce an alarm that such a large investment fund cannot–or should not–be audited by such a small firm. This sort of firm should have its financial statements audited by a reputable accounting firm and they should be provided to investors. Surely, Mr. Madoff was not simply being economical in choosing that small firm. In another example, it seems remarkable in hindsight that so many Americans would buy certificates of deposits issued by a bank in Antigua. Again, common sense should produce an alarm when a foreign bank on a small Caribbean island offers an investor such high interest rates on 'safe' CDs.

Why did investors fail to recognize Madoff's and Stanford's claims as mere illusions? A factor that persists across these and other schemes is that investors–and others–simply do not want to believe it is a fraud. For whatever reasons, their common sense or skepticism was replaced by wishful thinking. This seems to be part of human nature that we will probably see again. Since Charles Ponzi committed his infamous scheme around 1920, uncounted Ponzi schemes have occurred that have taken advantage of innocent investors. Unfortunately, with history as a guide, we will see more investment frauds in the future. Perhaps the best we can hope for is that some investors see the warning signs and then take early action rather than being tempted by too-good-to-be-true stories. ~~~

Forthcoming Empirical Research on Shareholder Litigation

A paper titled *Institutional Monitoring Through Shareholder Litigation* by C.S. Agnes Cheng of Louisiana State University, Henry Huang of Prairie View A&M University - College of Business Administration, Yinghua Li of Purdue University - Department of Accounting and Gerald J. Lobo of University of Houston - C.T. Bauer College of Business is forthcoming in the Journal of Financial Economics. The paper investigates the effectiveness of using securities class action lawsuits in monitoring defendant firms by institutional lead plaintiffs from two aspects: (1) immediate litigation outcomes, including the probability of surviving the motion to dismiss and the settlement amount, and (2) subsequent governance improvement such as changes in board independence. Using a large sample of securities lawsuits from 1996 to 2005, the authors show that securities class actions with institutional owners as lead plaintiffs are less likely to be dismissed and have larger monetary settlements than securities class actions with individual lead plaintiffs. This effect exists for various types of institutions including public pension funds.

Upcoming Launch of FASB Accounting Standards Codification™

FASB's Accounting Standards CodificationTM is set to officially launch on July 1, 2009. The Codification will become the single source of U.S. GAAP.

According to the June 3, 2009 press release, it will be effective for interim and annual periods that begin on or about July 1, 2009. All existing accounting standard documents are superseded. All other accounting literature not included in the Codification will be considered nonauthoritative.

FASB Chairman Robert Herz states, "The FASB is confident that preparers, auditors and users of financial statements...will find the Codification provides a much more efficient, user-friendly method of researching up-to-date solutions."

The Codification reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics. It includes relevant Securities and Exchange Commission (SEC) guidance that follows the same topical structure in separate sections in the Codification.

To prepare constituents for the change, the FASB has provided a number of tools and training resources including an online tutorial available on the Codification website at http://asc.fasb.org

The Codification does not change GAAP. Rather, it introduces a new structure, "one that is organized in an easily accessible, user-friendly online research system." The Codification excludes governmental accounting standards, includes all standards issued by a standard-setter within levels A through D of the pre-Codification GAAP hierarchy, including (among other documents) various FASB statements, interpretations, and bulletins, EITF abstracts, and AICPA statements, bulletins, and audit and accounting guides.

For more information on the forthcoming FASB's Accounting Standards CodificationTM, visit the FASB web site at www.fasb.org. ~~~

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Upcoming Events:

June:
M. Mard's column, "What'$ it Worth?", in The Licensing Journal

September:
September 22, 2009: M. Mard will attend the FASB Valuation Resource Group meeting
September 23, 2009: S. Hyden will attend the Appraisal Issues Task Force meeting

Look for our upcoming books:
Financial Valuation: Applications and Models (co-authors M. Mard and S. Hyden), and Financial Valuation Workbook (co-author M. Mard)