

User Views On Fair Value: Vinny Catalano, CFA, Randy Schostag, CFA

Feb. 24, 2009

FEI Summary

On Feb. 12, 2009, two users of financial statements were interviewed – Vinny Catalano and Randy Schostag, who are both Chartered Financial Analysts (CFAs) – to discuss their views on potential improvements to fair-value accounting. The interviews were conducted one day prior to the second meeting of the [Financial Crisis Advisory Group \(FCAG\)](#), a joint advisory group of the Financial Accounting Standards Board and the International Accounting Standards Board. Neither Catalano nor Schostag are members of FCAG, but the FCAG [agenda](#) provided food for thought on subjects such as: “With specific reference to fair value, should financial stability or pro-cyclicality be considered even if a loss of transparency of information would result?” and “What additional guidance, if any, is needed in the area of determining fair value?” [See separate [FEI summary of FCAG meeting](#).]

NOTE: On Feb. 18, 2009, FASB announced (see [FASB press release](#)) that it had added to its agenda certain short-term projects relating to fair-value accounting and disclosure. The interviews were conducted prior to that announcement (with the exception of some follow-up comments by Schostag).

Interviewees

About Vinny Catalano

Vinny Catalano is president and Global Investment Strategist with [Blue Marble Research](#) and author of *Sectors and Styles*. He is a chartered financial analyst (CFA) and past president of the New York Society of Security Analysts. Catalano appears regularly in the media (CNBC, Bloomberg Radio, National Public Radio, Canada's C- TV and BNN TV, New Delhi TV) and has been frequently quoted in various professional publications (*Wall Street Journal*, *Barrons*, *Financial Times*, *Fortune*, *Globe and Mail*, *Business Week*). He also produces and conducts numerous events with various CFA societies and other groups, including the highly popular "Market Forecast Series" as well as topical and educational programs. He authors the blog: [Vinny Catalano: Musing on the Markets](#).

About Randy Schostag

Randall (Randy) Schostag has conducted business analysis, valuations and deal structuring for more than 30 years. He is the founder of [Minnesota Business Valuation Group](#), a subsidiary of Olsen-Thielen, a large, regional certified public accounting firm. Randy is a chartered financial analyst (CFA), a master certified business appraiser (MCBA), an accredited senior appraiser (ASA), accredited valuation analyst (AVA) and holds the designation Business Valuator Accredited for Litigation (BVAL) from the Institute of Business Appraisers (IBA). He has provided litigation support on valuation matters, and his previous positions include serving as vice president and general manager of a commercial bank and a venture capital firm, and being cofounder of a manufacturing company. Read more in his [bio](#).

Prepared Feb. 23, 2009 by Edith Orenstein, director, Accounting Policy Analysis, Financial Executives International (FEI). This summary does not reflect FEI opinion unless specifically stated above.

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Interview: Vinny Catalano¹

About Vinny Catalano

Vinny Catalano is president and Global Investment Strategist with [Blue Marble Research](#) and author of *Sectors and Styles*. He is a chartered financial analyst (CFA) and past president of the New York Society of Security Analysts. Catalano appears regularly in the media (CNBC, Bloomberg Radio, National Public Radio, Canada's C- TV and BNN TV, New Delhi TV) and has been frequently quoted in various professional publications (*Wall Street Journal*, *Barrons*, *Financial Times*, *Fortune*, *Globe and Mail*, *Business Week*). He also produces and conducts numerous events with various CFA societies and other groups, including the highly popular "Market Forecast Series" as well as topical and educational programs. He authors the blog: [Vinny Catalano: Musing on the Markets](#).

Q: What are your thoughts on the issue of accounting serving financial stability objectives versus transparency objectives?

Catalano: I think fair value is here to stay; the opportunity to eliminate it has come and gone. However, the banks are going to look for a way to live with it. For example, see what I wrote today [Feb. 12] in my blog on: [Pandit's Amortization Trial Balloon: Can It Float U.S. Out of the Crisis?](#) [*Here is an excerpt from Catalano's blog post, referencing testimony given by Citigroup CEO Vikram Pandit and others at Feb. 11 House Financial Services hearing at which seven CEOs testified on use of TARP funds*):

In reply to a question from Congressman Gutierrez from Illinois – who started off referencing a meeting the congressman and Mr. Pandit had the day before – Mr. Pandit, with an intriguing smile on his face, described what sounded to me like an [amortization](#) scheme in which the mark-to-market created losses for certain assets could be realized by the banks, not as an immediate and complete hit to the income statement (thereby impacting the balance sheet and, therefrom, the capital requirements of the bank), but on an amortized basis over time, which will have the effect of limiting the preposterous losses induced by illiquid markets and their last sale/"fair value" price.

To refresh your memory, mark-to-market is an ancient theory tied to the belief that markets are efficient and that the last price represents the fair value of an asset. This is an absurd view of reality and human nature – one that should have died a long time ago but still lingers in the minds and hearts of the free-market advocates and their closet efficient market cohorts (who don't have quite the faith in unfettered markets as free-market advocates do, yet still can't buy into the behavioral-science fact of inefficient markets in illiquid assets and over short time frames).

The Pandit amortization balloon would, in effect, achieve what the alteration and/or elimination of mark-to-market would have accomplished – a conciliation between the last sale = fair value mark-to-market ideologues and those grounded in the reality of the behavioral sciences. In other words, a normalization of value that could be adjusted when markets are less stressed ...

Mark-to-market, the disastrous decision that turned a bad recession into a credit – and now economic – crisis, needs to be dealt with. Since the forces aligned against its elimination and/or modification are too formidable for the current and past government officials to overcome, getting around the insane rules is the next best thing. Amortizing the losses for illiquid assets with the prospects of capturing any price recovery would make infinitely more sense than continuing the current regime of efficient-market fantasy thought.

Who knows what plans are being hatched behind closed doors. Maybe the above scenario is wishful thinking on my part. However, if this or some variation of getting around the consequences of mark-to-market, produces anything that approaches the above scenario, the economic crisis will clearly become a whole lot less intense. And the global economy will benefit immensely.

Maybe that's why [stocks](#) have withstood so much recent bad news and appear to be building a solid base for a sustainable rally.

In other words... there is a model for how to deal with losses that do not have to be taken all at once, but by amortizing losses over time, while retaining the ability to adjust value somewhere in the future, so when assets become more normalized or the asset reaches maturity, then mark-to-market becomes a moot point.

¹ This interview was conducted prior to FASB's Feb. 18, 2009 [announcement](#) that it will embark on a short-term project to improve the 'application guidance' for determining fair value in inactive markets and fair value disclosures. "

Q: You have written frequently in your blog about the current state of the economy, and you sometimes have referenced accounting issues. Do you want to comment on the potential implications of fair-value (mark-to-market) accounting vis-à-vis the U.S. Treasury Department's [Financial Stability Plan](#), announced on Feb. 10 by U.S. Treasury Secretary Tim Geithner?

Catalano: The question is “how do you satisfy those who believe in mark-to-market – with toxic assets – that the U.S. Treasury Department wants to move into a public-private investment bank (PPIB);” how do you work a balance between taking assets off the books of banks, sticking them into the PPIB, and at what price?

The hedge funds and taxpayers are going to demand they buy the assets at the cheapest possible price, but if you do that, the banks might be hit more, e.g., if they are carrying an asset at 50 cents on the dollar on their books, but sell it for 20 cents, that leads to capital impairments, and the banks may become insolvent, need more capital to be infused, causing a never ending spiral. But if, *[as Pandit appears to have recommended, noted above]* instead, you don't have to take the 30 cent hit all at once, if you can amortize it, carry it on the balance sheet and have it hit over a five-year period of time, and at the end of that period the bank has some kind of note, that if it gets any upside benefit, if it closes out at 60 cents on the dollar, the bank then claims a gain.

Of the \$1.4 trillion of Alt-A and subprime mortgages, roughly \$450 billion is delinquent, but not in default, roughly \$950 billion is current, carried on the books at something that resembles full value, but what are they trading for – 50 cents on the dollar? They are current, people aren't delinquent, not late, not in default; ...if you force those banks to take 50 cents on the dollar and give the loans to the PPIB at 50 cents on the dollar, they get a big hit all in real time, and secondly they have no recourse (upside potential).

Geithner even said he accepts fair value; there's no move for the modification or repeal of FAS 157; if there isn't, then accept it as a given, and the question then is, how can you get around that, in light of taking toxic assets off the books that create a constant never-ending chaos, get them into a “bad bank,” but those investors will demand they buy it at fair value, and the bank ultimately gets hurt. Geithner will consult with the G-7 this weekend, then he'll have meetings with all the [George Soros's](#) and all the hedge funds.

Q. Do you believe fair value accounting should be modified? If so, how?

Catalano: FAS 157 should be modified, I've argued for it to be modified in some shape or form. You could do some moving average price, or mark to maturity, which was floated by Federal Reserve Board Chairman Bernanke many months ago, but the idea didn't go anywhere. I think it's a good way to go, but you have too many economists, like [Paul Krugman](#), who buy into this efficient market, fair value argument; if you don't have Krugman, who's a liberal economist, arguing against it, he becomes a free-market advocate, [then] where's the support going to come from for modification?

You have [William \(Bill\) Isaac](#) and recently [Robert Rubin](#), in his 92nd St. Y appearance, and [Paul Volcker](#), [talking about the need to modify fair value], but they gained no traction; therefore, let's accept fair value as a given, and FAS 157, it's all a given. Therefore, I think the way they're going to try and do this, now that they're forced into dealing with the toxic assets, they've got to get them off the books; otherwise, you've got to go the path [\[Nouriel\] Roubini](#) talks about, which is, blow up the shareholders, nationalize banks - that would be a crime when you go that insolvent bank route. The problem is, there's illiquid markets, no transactions taking place, or taking place at distressed values.

Q. What about the question of a potential tradeoff between, or sacrifice of transparency for financial stability, as referenced in the FCAG [agenda paper \(pg 2\)](#)?

Catalano: They should consider loss of transparency, but if you want to keep transparency, find some other way for fair value to be modified. I believe FAS 157 should be modified, and the use of last sale price – that faux transparency – should be replaced by another form of transparency, which is better disclosure by the bank regarding the status of that particular mortgage or instrument.

In other words, they would have to disclose more in the way of where things stand. And, you can calculate what the value is, you don't need the marketplace to tell you – in its wisdom – what the value is, if it is current; you can calculate an estimate based on past experience. Why do you need the marketplace to be the arbiter of what the future holds?

All bonds trade at discounted cash flow; the only reason they might vary is if the marketplace determined value should be different from normal spread over treasuries, you can find that disruption right now in the high-yield market. If you go by the current spread over treasuries and credit default swaps, and yet, every estimate at the top echelon of understanding in the high-yield market, their estimate is that default rates in this part of the economic cycle, if it hits 20 percent, it will be a lot, but prices on a mark-to-market basis are at 70 percent default rates, there is an example of the marketplace misrepresenting fair value.

Fear, procyclicality, illiquid markets, over the very short term, fair value should not be determined based on illiquid markets over a very short period of time, exactly for this point – because of what [behavioral science](#) has shown to be the case; however you still have [\[Paul\] Krugman](#) and others holding onto [efficient markets](#), out of the [Modern Portfolio Theory](#) of [Harry Markowitz](#). But behavioral scientists came on in the 1970s and said, “This is nuts.” You had [Daniel Kahneman and Vernon Smith](#), Nobel Prize winners for their work on behavioral finance. *[For more information on behavioral finance/behavioral economics as relates to, among other things, mark-to-market accounting, see Catalano’s blog posts of [Feb. 5, 2009](#), [Jan. 28, 2009](#), [Sept. 10, 2008](#), [March 20, 2008](#), and [March 18, 2008](#).]*

NEXT PAGE: INTERVIEW OF RANDY SCHOSTAG, CFA

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Interview: Randy Schostag ²

About Randy Schostag

Randall (Randy) Schostag has conducted business analysis, valuations and deal structuring for more than 30 years. He is the founder of [Minnesota Business Valuation Group](#), a subsidiary of Olsen-Thielen, a large, regional certified public accounting firm. Randy is a chartered financial analyst (CFA), a master certified business appraiser (MCBA), an accredited senior appraiser (ASA), accredited valuation analyst (AVA) and holds the designation Business Valuator Accredited for Litigation (BVAL) from the Institute of Business Appraisers (IBA). He has provided litigation support on valuation matters, and his previous positions include serving as vice president and general manager of a commercial bank and a venture capital firm, and being cofounder of a manufacturing company. Read more in his [bio](#).

Q: What are your thoughts on the issue of accounting serving financial stability objectives vs. transparency objectives?

Schostag: It seems to me in looking at the [FCAG] [agenda paper](#), the group should really reconsider reframing the questions; from the very nature of their questions it seems that they are missing what I believe is the frustration that exists in the financial user community.

They are saying, in their opening remarks (pg. 2 of the agenda paper), that the session objective is: "Should general purpose financial statements have a financial stability objective, why or why not?" The short answer to that is "no, the financial statements should be showing us an accurate picture of financial condition at a given point in time, and financial performance for a period of time." I don't see anything personally within that definition that has anything to do with financial stability.

That leads to the next point in the agenda: "Should financial stability or procyclicality be considered even if a loss of transparency of information would result?" Again, the answer is "no, it's not financial statements' job to have a financial stability objective – it's the regulators' job." But there has to be a way that we, financial statement users, can look at that information, and see where a company is.

There are several places in here [the FCAG agenda paper] where they mention the IASB's *Framework for the Preparation and Presentation of Financial Statements*, which talks about various users, e.g. it talks about investors who provide risk capital, and indicates those investors should be their primary target [of financial reporting]. But what about anyone who does not have internal access and is able to request and require additional information, those financial statements or presentations should tell them the financial condition or performance of an entity, the user may be a banker, who would have to have reliance on that financial information.

Does that mean the stated objective (of financial reporting) would necessarily preclude some of these other users from gaining useful information from the reports? This agenda paper says, "Primacy is **not** given to the needs of governments and their agencies or to lending financial institutions and credit rating agencies, for example, because those entities typically have the power to obtain additional financial information directly from management. Typically, most investors do not have this power." As an ex-banker, I have to be able to have a true picture of an entity's financial condition and performance.

Q. Do you believe fair value accounting should be modified? If so, how?

Schostag: I do not believe FAS 157 (*Fair Value Measurement*) as it currently exists, provides a reasonable basis to determine what the fair value of a security holding is, based on the methodology set forth in that standard. Of course that depends on how you define fair value. But it's disingenuous to set forth a term like fair value and then expect financial statement users to not have strong expectations as to what it means. I suspect that by using that term and requiring its application in an audit that the financial statement users will rely on the values reported as indicative of what can be expected in the market place.

Perhaps, if some of the comments I've read from various people, including from some regulatory groups, are true – that FAS 157 is not as restrictive as the language would appear to make it – then maybe FAS 157 as it exists today might actually be acceptable. However, those of us in the field, who actually have to live with FAS 157, do not and have not interpreted the language to be anything other than restrictive and

² This interview was conducted prior to FASB's Feb. 18, 2009 [announcement](#) that it will embark on a short-term project to improve the 'application guidance' for determining fair value in inactive markets and fair value disclosures; a follow-up question was asked on Feb. 20, 2009 as noted further below.

counter intuitive. FAS 157 makes it very difficult to use any method or approach other than a very simple mark-to-market model. That's because the standard requires mark-to-market with little requirement to justify its use and with no requirement to spell out any weaknesses or shortcomings, but then mandates that if any other method is used, it must be accompanied by strong documentation.

[The next comments refer to FAS 157's hierarchy of fair value inputs – referred to as Level 1, 2 and 3 – which in simplified terms, refers to a range from observable market values for that asset (level 1), to observable or hypothetical market values for similar assets (level 2), to a lack of observable or hypothetical market values due to, among other potential reasons, illiquid markets (level 3).]

If you don't fall into bucket 1 or 2, the analyst has a really tough time setting up the justification for using inputs other than market prices. That's why discounted cash flow becomes problematic. However, even at level 2 where market values of other observable assets are used to ascertain pricing, it is sometimes difficult for the auditor to justify the values. That's in part because analysts' judgment is used to determine what other company or asset prices are comparable. Therefore under FAS 157 even with observable inputs, there are a number of questions how Level 2 should be applied. Level 3 becomes really problematic. Neither the analyst nor the auditor are going to want to step out there and become vulnerable to later criticism when the standard would seem to discourage such usage.

Within the board apparently some have said they are surprised that reports for 2008 have shown very few analysts or auditors use level 3 for obtaining pricing (*i.e. classifying assets as level 3 assets, which permits use of more judgment in arriving at the valuation, in the absence of, e.g. liquid markets*); I personally am not surprised. We're discouraged from using level 3, in the way FAS 157 is written.

The theory of mark-to-market or fair-value accounting in FAS 157, without reference to any other modeling for pricing, is contrary to everything in business appraisal and corporate finance, with regards to how to estimate the value of a company or security. I have to restate that for emphasis. FAS 157 now discourages analysts and auditors from using anything other than mark-to-market methods, and this is contrary to everything in business appraisal and corporate finance.

There is an established body of knowledge, in both the courts as well as that which has been established over time by certified appraisal organizations, which requires the use of three approaches to value: the market approach (same as mark-to-market); the income approach (e.g. discounted cash flows) and the asset-based approach. Following an examination of all three of these approaches, an analyst should reconcile any differences in value which may exist among these three approaches, and determine why there is a difference, before setting a price.

Q. Wouldn't that be costly to produce (i.e. the requirements for certified valuation engagements)?

Schostag: There is no question what I just suggested is both time consuming and expensive. In the absence of that, are we willing to sign off on something that is anything less complete? In other words, if we say, "There should be a three-legged stool, but now in this audit report, we've used only one approach – one leg - and here's the value," is that defensible? When presented in a financial statement, shouldn't the financial statement user be able to believe that there has been sufficient due diligence so that the value reported is reflective of a market value? I can assure you that if I went to court to defend a value using only one approach such as set forth in FAS 157 for a valuation for gifting, estate, divorce, employee stock ownership plans, or shareholder disputes, the court would likely throw out my testimony as inadequate.

Q. What would you suggest as an approach to be more reflective of fair value?

Schostag: It would seem as though fair value (as set forth in FAS 157) was created primarily as an extension of what SEC and FASB have done in past, without regard to the standards of value that have already been developed within the marketplace.

A very strong valuation model has evolved over time and has been used for years: that standard of value is fair market value, which is presently required by the Internal Revenue Service, by the Department of Labor, and for many other purposes. The definition of fair market value includes, among other things, a hypothetical willing seller, a hypothetical willing buyer, both with assumed knowledge of the investment they are looking at, and neither one acting under any duress, as defined by IRS Revenue Ruling No. 59-60. *[See related article published by Potomac Valuation Services on [IRS Rev Ruling 59-60](#).]* One of the most frequent comments I hear from appraisers at conferences is that FASB created a great deal of confusion by not simply adopting fair market value as the standard of value. Many of the problems that

are now coming to the surface are around issues such as market participant that depart from definitions already in common usage.

FAS 157's fair value doesn't mirror fair market value, in which you have to look at eight different factors. In this new standard we say, "this is reflective of market value," but it doesn't necessarily. It fails to consider those limitations. There have to be some processes developed such that those additional factors can be considered. We shouldn't hold out any standard of value which gives anything less than a meaningful value which can be relied on the financial statement user. Otherwise we're creating a false sense of security, a sense of precision that just doesn't exist. It undermines confidence in the financial reporting and will be interpreted by statement users as meaningless.

Additionally, fair value, as defined in FAS 157, says we're supposed to use the price that would be paid by a "market participant." I get questions from all over the country from appraisers and accountants who need to do audits on various funds, who ask, "What the heck is a market participant?" I think that a very good issue FASB could address at the beginning would be to reexamine the underlying rationale of the market participant requirement.

The AICPA – almost at the same time FASB was issuing FAS 157 – was preparing to issue the [Statement on Standards for Valuation Services, No. 1](#) (SSVS1). In that standard for CPAs, a valuation is either a "calculation" or an "engagement." If it is a calculation it must be clear what it does **not** do, i.e., it does not perform a proper and full valuation. There is no such disclaimer asked for when auditors use values based on FAS 157. But as we've discussed, by emphasizing the market approach and discouraging other approaches, FAS 157 sets up the value to be something less than obtained by an engagement in compliance with SSVS 1. Yet the consuming public of financial statements are not being advised of this limitation with respect to FAS 157 reporting. Shouldn't the financial statement user be confident that at least within the same body – accounting – there will be consistencies?

My point is that FAS 157 is among the rules that have been issued for use by accountants in recent years in the name of transparency – and that provide a false sense of confidence in reporting.

Q: Do you believe there is room for a blended view, between what the professional standards for certified valuation appraisers apply for valuation engagements including under SSVS1 and Rev Ruling 59-60, and the exit value or market-participants approach that FAS 157 now requires, to incorporate the use of more judgment by preparers and auditors in looking at alternative valuation models, or perhaps a limited set of valuation models – particularly in inactive markets, e.g., market price and discounted cash flow?

Schostag: I think that a blended view already exists wherein the SEC and FASB can use what is already available and which are becoming much more user friendly. I'm referencing here the enormous body of data which the SEC has made available through EDGAR and with its adoption of XBRL (eXtensible Business Reporting Language) for financial reporting. The SEC was justified in the past to rely almost exclusively on using mark-to-market because it was so time consuming to obtain other information, notably specific information about financial performance of an entity or group of entities. But the advent of personal computers, the development of peer reviewed and accepted methodologies which go beyond simple marking to market now enable appraisers and auditors to use automated and semi automated tools to determine values. The outputs could be tested for accuracy and robustness, providing the means for an auditor to quantitatively obtain and display results for confidence levels. Using such tools should also reduce the turnaround time for developing reports for use in the financial statements and also reduce the cost.

Q. Given that the stated objective of FAS 157 was (as described on [pg 3 of FAS 157](#) in its summary) to "increase[e] consistency and comparability in fair value measurements and ... expan[d] disclosures about fair value measurements" – how would you –as a user of financial statements – feel if the number of measurement bases for fair value measurement were broadened, particularly in inactive markets?

Schostag: I personally believe that if the measurement bases were broadened to consider the other demonstrated methods and approaches to ascertain value that financial statement users could be more confident in the financial reporting of values.

FOLLOW-UP QUESTIONS WITH RANDY SCHOSTAG– FEB. 20, 2009

Q: What is your reaction to FASB’s Feb. 18 announcement <http://www.fasb.org/news/nr021809.shtml> that it will embark on providing additional application guidance on fair value?

Schostag: I’ve been very encouraged by recent announcements. At first blush it certainly appears that FASB, the SEC, and others are finally beginning to understand many of the weaknesses in FAS 157 and our financial reporting. To be frank, however, we’ve seen how politics gets in the way of rule making for the real world. So I am waiting to see how much of the rhetoric sees its way to improvements.

Q. Do you believe the net present value formula that HUD is expected to release on March 4 will have any impact on how fair value or mark-to-market is applied? For example, see this article “The NPV [Net Present Value] Test: A Line in the Sand on March 4” published in Seeking Alpha on Feb. 19, by Rakesh Saxena <http://seekingalpha.com/article/121361-the-npv-test-a-line-in-the-sand-on-march-4>, which states: “[P]erhaps unintentionally, the constituents of the NPV methodology will provide a fresh window into the value of hundreds of billions of dollars worth of Level 2 and Level 3 assets (per FSAS 157) on the books of Wall Street’s banks.”

Schostag: The devil is always in the details, and I’m not familiar enough with the NPV formula to make a judgment on it. But the overall concept seems reasonable, i.e., use a measure of future expected cash flow discounted to present value instead of looking only at a mark-to-market valuation. That is what most of us in the field have been lobbying for. What I haven’t seen, and what is necessary when using this method, is some way to assess the risk of receiving those future cash flows. There are ways to model that risk, and it’s imperative to add that component before settling on a value. The use of a NPV test is clearly a direction I’d like to see in more debate and application.

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