FAIR VALUE OR FRAUDULENT MISREPRESENTATION?

How complex commercial disputes can benefit from engaging experts on the fundamentals of Fair Value accounting

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The misuse of Fair Value (sometimes called Mark-to-Market) accounting has been at the heart of several high-value accounting scandals. Perhaps the most infamous instance was exposed in the collapse of Enron in 2001, where extensive misapplication of Fair Value fraudulently inflated reported profits. Despite this very public case, more recent history, such as the near-collapse of Noble Group, shows that the problem has not gone away. In today's difficult Covid business climate and the uncertain economic recovery to follow, commercial disputes are likely to force more of such cases to light, and counsel may need to call upon experts in Fair Value accounting standards.

To differentiate between the appropriate application versus misuse of Fair Value, companies need advisers who are clear on what Fair Value is and, equally, what it is not. Put simply, the Fair Value of an asset (or liability) is the price at which it could be sold, in an arm's length transaction, on the reporting date. In many cases, there is little room for interpretation of this definition; for example, assets with an observable market price such as listed shares traded on a public stock exchange. Outside such straightforward situations, it falls to management to choose an appropriate valuation technique. Therein lies the potential for legal argumentation.

The line between judgment and manipulation

The selection of a valuation technique and appropriate data inputs inevitably involves some judgment and, therefore, elements of subjectivity. Minimal judgment is needed for many Fair Valued assets; e.g. where there are economically similar assets with observable market prices. However, the application of Fair Value to illiquid or unique assets opens the door for potential manipulation.

Differentiating between good faith judgments and illegitimate manipulation can be a difficult legal challenge. One indication of potential manipulation a forensic accountant would look for is where the valuation technique diverges from the definition of Fair Value. In our experience, examples of invalid valuation techniques include:

- Valuing the asset from the perspective of the company owning the asset;
- Using 'Quoted Prices' where there is no intention and/or ability to transact at the 'Quoted Price';
- Discounting forecast profits, without regard to whether the asset could be sold at the resulting value; and
- Use of broad discretion by management to determine the value (so called 'Mark to Management').

In the Noble Group accounting scandal, long-dated mining contracts were valued by using optimistic management projections of future cash flows, discounted to produce a valuation which was presented as Fair Value in the accounts. Little regard was given to the inherent risks of delivering the project and the valuation had no relationship to the price a third party would be willing to pay to acquire the projects from Noble Group.

Recently, FRA was engaged by a law firm to give expert evidence in a post M&A arbitration in which a central issue was whether the Fair Value of certain commodity forward contracts had been misstated in the Financial Statements. It was argued that Fair Value was an estimate and therefore management was permitted broad discretion in determining it; for example, opting to disregard costs of transporting the commodities to market. One of the key arguments we used to help counsel defeat this assertion was to clearly explain the definition of Fair Value and its application to the contracts in question.

As the global pandemic stretches into its second year, so does the business challenge to deliver results and the temptation to look to accounting means, including Fair Value, to achieve this. Expect auditors and audit committees to pay increasing attention to the risk of manipulation. The ability to justify Fair Values matters most if they are called into question down the line.

Then there will be significant scrutiny around judgment calls and whether the right valuation experts were on the team at that time. Having a clear grasp of the definition is the best way for companies and counsel to clarify the line between judgment and manipulation. The first big step is asking: would an independent third party buy the asset at this price?

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