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air value is a valuation hierarchy that classifies the reliability of input used to arrive at an asset valuation. It was first defined in the Statement of Financial Accounting Standards (SFAS) #157 by the Financial Accounting Standards Board (FASB) in 2007. As international accounting standards converge and increasingly call for fair value rather than historical or market value, understanding it becomes essential.

Fair value consists of three valuation levels: Level 1 being the most reliable, and level 3 the least. Level 1 uses observable (market-based) input to measure the hypothetical sale price (called the "exit position"), on a specific measurement date, within the most favorable market, and in consideration of the best use of an asset.

If the direct value cannot be assessed following Level 1 criteria, Level 2 uses indirect but observable inputs (which may be further adjusted) to derive value. For example, if there is no active market for an asset, then data from an inactive market can be used. If no market has ever existed for identical assets, then data about similar assets can be used from active or inactive markets. Level 2 is concerned with observable inputs--like level 1--but its inputs are less current, precise, or specific.

If no market exists, or ever has, for the asset or any asset similar to it, or if insufficient observable inputs are available, then Level 3 criteria are used. Level 3 uses unobservable inputs provided by the owner (the reporting entity) including value/income projections, forecasts, book valuations, or other assessments. Imagine buying a prototype car from the man who invented it. Since there is only one car like it, there is no Level 1 data. Imagine, also, that the car is so different, that there is not and has never been any car similar to it, and that it has had only one owner, so there is no Level 2 data. Suppose, finally, that the owner tells you all about the car, how much it cost to make, that it has traveled 200,000 kilometers and never broken down, and that it will go another 200,000 kilometers for you.

As you might guess, unobservable, unverifiable information, provided by the owner of an asset (for which there is no comparison) is the least reliable input. Level 3 criteria should, therefore, be used only as a last resort, or to corroborate a level 1 or 2 assessment. No matter what level the valuation, the inputs used must be disclosed by the valuation professional. Furthermore, fair value implies that any hypothetical sale must take place between knowledgeable, willing, and able buyers. It cannot be a forced sale (e.g. a foreclosure).

Fair Value is not a valuation technique: it is a hierarchy measuring the reliability of inputs used to arrive at a valuation. As a metaphor, it is not an Olympic gymnast's technique; it is the Gold, Silver or Bronze medal hanging on her neck.

No asset, anywhere, ever, has an absolute value; "fair" remains relative. Yet, by understanding the relative reliability of how value is determined, both buyers and sellers may make more informed decisions.

*Carol Ortega Algarra.*