MERCER CAPITAL'S

Value Matters™

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Reasonable Valuation of Illiquid Mortgage-Backed Securities

An unprecedented wave of home mortgage defaults has triggered a widely publicized fallout in the subprime lending market in recent months. As a result, uncertainty has dampened investor enthusiasm for all mortgage-backed securities. While such securities trade in a dealer market that was relatively liquid just a few months ago, bids are now rare for many issues, making it difficult for companies to estimate and report relevant and reliable values for accounting purposes.

CONCEPT OF FAIR VALUE

Current accounting rules require companies to report such securities on the basis of fair value, which is defined in SFAS 157 as "the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date." Two elements of the fair value definition – "market participants" and "an orderly transaction" – specifically pertain to the determination of the fair value of suddenly illiquid securities. In SFAS 157, a market participant is defined as 1) an unrelated party, 2) knowledgeable of the subject asset, 3) able to transact, and 4) motivated but not compelled to transact. When liquidity drains from the market for a given asset (in other words, when there are fewer market participants), "real-world" market evidence becomes more scarce and the fair value presumption of an orderly transaction necessarily becomes more hypothetical. In other words, fair value is not always exactly the same thing as the widely-held notion of "current value" espoused in the popular businesss media.

To minimize input risk and increase "consistency and comparability" in fair value measurements, SFAS 157 introduces a fair value hierarchy that prioritizes fair value measurement inputs into three broad levels, giving highest priority to quoted prices in active markets for identical securities (Level 1) and lowest priority to unobservable inputs (Level 3). Level 2 inputs include observable inputs that require some adjustment for the fair value measurement[1]. When a security is traded in an active market, its fair value is the current observable market price, a Level 1 input; however, the process of fair value determination becomes trickier when there is no active market for a given security.

MARKET INDICATIONS OF VALUE

In the United States, there is no centralized exchange for mortgage-backed securities; the secondary market is comprised by a network of brokers dealing in a particular security, and therefore is not as transparent as the public equity or corporate debt markets. When securities are actively traded in orderly transactions among a large number of market participants, these markets provide reasonable indications of fair value. Unfortunately for financial managers charged with reporting fair value, the markets for many securities have become illiquid.

The recent market illiquidity has exacerbated the structural opacity of the mortgage-backed market, rendering many market-based indications of valuations unreliable at best, meaningless at worst. A *Wall Street Journal* article from August 2007 quotes one vexed manager: "Someone says they're worth 50, and someone else says 90, and you can't sell at 30 because there aren't any bids." The valuation problem born of the current illiquidity is not that the markets are reliably providing low indications of value, but rather that they aren't reliably providing any indications of value.

INSIDE

RELIABILITY OF VALUATION MODELS

In the absence of reliable market evidence, companies and funds have begun using valuation models to measure the fair value of these securities using Level 2 and Level 3 inputs. According to the FASB conceptual framework, accounting information should be "relevant and reliable." Fair value measurements based on lower-level inputs are certainly relevant to users of financial statements; financial managers and auditors must focus on maintaining the reliability of these estimates.

Recent news stories in the popular business media have questioned the reliability of these estimates, citing cases of earnings manipulation by management and the inherent subjectivity in the determination of accounting estimates. Fair value accounting did not introduce these risks. Beyond simply decrying these risks, they should be accepted, disclosed, and appropriately managed—after all, "it is better to be approximately right than precisely wrong."

Two important factors that influence the overall reliability of fair value measurements using Level 2 and 3 inputs are proficiency and independence. Proficiency is grounded in a thorough knowledge of the relevant accounting guidance, as well as the requisite valuation expertise and experience to make appropriate valuation judgments. While preparation of fair value measurements by a reporting company's own staff is not prohibited, retaining an outside valuation specialist can facilitate reliability by ensuring proficiency in the process of fair value determination many securities.

Independence in accounting measurements has traditionally been the auditor's task. Fair value measurements, however—especially those of complex illiquid derivative securities—have put auditors in a strange position due to the significant valuation judgments required. In situations characterized by significant scrutiny and investor uncertainty related to the reliability of estimates (i.e. the current MBS situation), use of an independent outside specialist can enhance the credibility of fair value measurements.

Management compensation structures are a common instigator of conflicts of interest in financial reporting. Management bonus structures are often directly tied to the value of securities held, and thus provide a significant incentive to inflate valuations of such securities. While this incentive to manipulate financial results is nothing new to accounting, the advent of fair value does increase the need for independence in the determination of accounting estimates. If management compensation depends on the value of illiquid securities, an internal estimation of fair value will rarely satisfy the standard for reliability, but outside support from an independent valuation specialist is one way to alleviate this conflict.

THE VALUE OF REASONABLE ESTIMATES

Illiquid securities of any kind are by nature difficult to value, but accounting standards require companies to report the fair value of such securities in the most reliable fashion possible. Given the degree of regulator scrutiny and investor demands, companies should have valuation policies detailing practices to promote the most reliable fair value estimates. Having such policies not only promotes market transparency, but also carries pragmatic benefits for the company itself. The potential for misreporting fair value estimates carries significant risk to a company and management; a thorough plan to ensure the reliability of such estimates mitigates this risk significantly.

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[1]Note that observable inputs are inputs that reflect the assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources, while unobservable inputs are those inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability.

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December 4, 2007
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New Orleans, Louisiana
"The Discounted Cash Flow Method: A to Z"
Travis W. Harms, CFA, CPA/ABV

December 5, 2007
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Baltimore, Maryland
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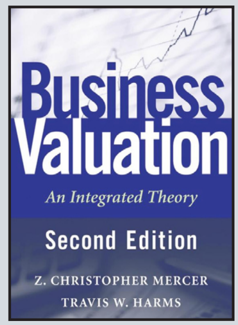

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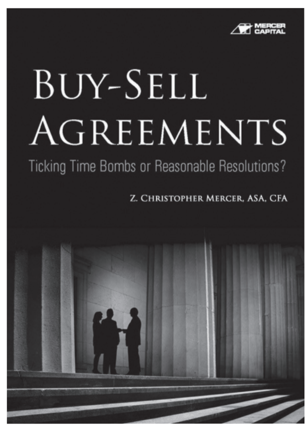

L. PAUL HOOD, ESQ.
Steve Leimberg's Business Entities Newsletter, Issue 119, February 13, 2007.
Courtesy: Leimberg Information Services, Inc. (LISI) at www.leimbergservices.com

In the teacher's manual to our *Business Associations* case book, my friend, colleague and coauthor Bill Klein posits that "any lawyer who advises people entering into a business venture and who fails to urge the adoption of a buy-sell agreement is guilty of malpractice." Z. Christopher Mercer's new book *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions* offers a tremendously useful guide to these remarkably important contracts. In it, he provides guidance for business people and their financial advisors to use in assessing the need for a buy-sell agreement and, if one is appropriate, deciding on key terms. It will also be very useful to counsel drafting buy-sell provisions, as it offers drafting checklists and samples of how various issues can be treated. I recommend it very highly.

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DAVID A. ELLNER, CPA/ABV
The Financial Valuation Group
Published in the AICPA ABV e-Alert
Volume 9, Issue 2, February/March 2007

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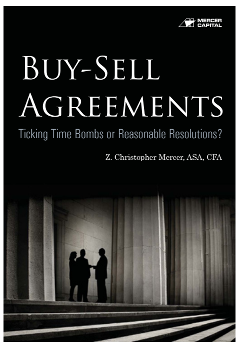
TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?



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