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Making Sense of Fair-value Accounting

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Making sense of fair-value accounting

In today's heightened uncertainty, what is needed is more transparency, not less

By **ANDREW LEE** and **LIM CHU YEONG**

FINANCIAL markets have long been regarded as the paragon of perfect competition. When there are many buyers and sellers and there is an adequate flow of information, the market price of an asset reflects the collective wisdom of all participants and represents fairly its intrinsic value.

Of course, markets can still function reasonably well even if they are not ideally perfect. They just need to be sufficiently competitive.

However, when critical conditions for perfect competition are badly breached, markets break down; buyers and sellers become extremely hesitant to trade or they disappear from the market completely; prices fluctuate outrageously and they no longer reflect fairly intrinsic values. Economists term this phenomenon a market failure.

We clearly see this in the recent state of credit markets, where bid-ask spreads widen, default risk premiums surge even for hitherto strong borrowers, and banks become very reluctant to lend even to one another. Market liquidity evaporates on heightened concerns and lack of information about the true quality of the financial assets as well as the ability of counterparties of financial contracts to honour their commitments.

Proponents of fair-value accounting standards, introduced over the last decade, have always argued that recognising financial assets and liabilities at their fair values on an entity's financial statements would provide more relevant information to investors than historical cost numbers. Numerous academic studies have also found evidence in support of this argument.

But the fair-value accounting model is not without its limitations. Fair-value accounting may be fraught with difficulties when asset markets are inactive or non-existent.

Accounting standards acknowledge this. For instance, where asset markets are inactive, international accounting standards permit entities to adopt mark-to-model accounting in place of mark-to-market accounting. Under mark-to-model accounting, an entity uses fair values, estimated from generally accepted valuation models, as proxies for actual market values.

Under US accounting standards, entities also have to segregate the fair values of their financial instruments into three different hierarchical levels:

- ◆ Level 1 fair values are those obtained directly from quoted prices in active markets. These values are considered to be objective and unbiased. An example would be shares listed and actively traded on a stock exchange.
- ◆ Level 2 fair values are those that are not directly obtained from quoted prices but can be derived from observable market data. An example would be plain-vanilla interest rate swaps based on Libor swap rates.
- ◆ Level 3 fair values are those that cannot be obtained or derived from observable market data but are determined using internal valuation models, hence the term mark-to-model. An example would be asset-backed securities that are not actively traded.

Most issues in practical applications of fair-value accounting arise from Level 3 (and at times Level 2) estimates. Such estimates are subject to differences in assumptions on models and parameters.

Despite the inherent difficulties of Level 2 and Level 3 fair-value estimates, we are of the view that they are better than no estimates at all, as long as adequate controls are in place to mitigate the difficulties. That these estimates are not precise is no different from the many other estimates in accounting, such as provisions.

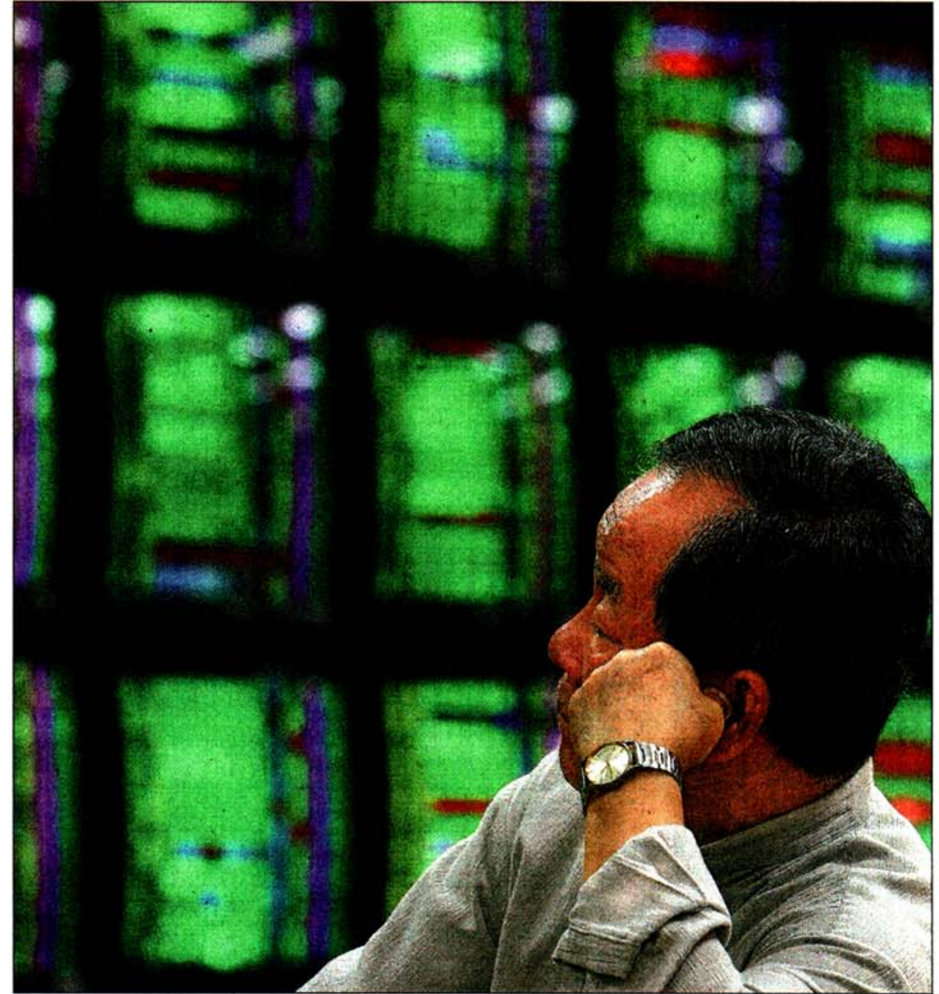
Banks have in-house valuation specialists to determine the fair values of their financial instruments, and auditors assess, among other things, whether the bank's valuation function is sufficiently independent of its front office. Some audit firms may also engage their own in-house valuation experts to further assess the reasonableness of the banks' fair-value estimates.

Governance issue

Of course, it is possible that entities under extreme pressure to deliver favourable performance might still temper with such estimates. But this is more an issue of governance than valuation.

To enhance transparency, we think that entities should disclose more details and breakdown on the valuation of their financial instruments, including their related movements and recognised fair-value changes, at each hierarchical level.

The basis and assumptions behind such fair-value estimates should also be disclosed. Investors can then assess for themselves the extent to which they are prepared to rely on the different types of fair-value numbers.



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Regulators' role: *With markets now suffering from a confidence crisis, the immediate task is for regulators to restore confidence and stabilise markets*

Some critics have recently suggested that fair-value accounting has contributed to the current turmoil in financial markets and should be suspended. They argue that insistence on fair-value accounting rules has resulted in writedowns of financial assets by entities that not only grossly underestimate their true intrinsic values but also exacerbate the price meltdowns of similar assets or even of the entities' own shares.

However, such arguments, if valid, should also apply during times of rising prices. To say that fair-value accounting is flawed when prices are falling precipitously but works well when prices are rising would be biased. It destroys the very neutrality of accounting.

If fair-value estimates are suppressed for an asset class as ubiquitous as financial instruments, accounting would not fulfil its role of providing relevant information to investors. If fair values are problematic because of illiquid or abnormal market conditions, then what we need may be greater transparency and disclosure as well as a more effective market mechanism for mitigating counterparty and settlement risk.

It is interesting to note that while credit markets especially in the United States have substantially frozen during the recent turmoil, equity and currency markets continue to function quite effectively. Despite surging volatility and falling equity prices, trading in equities and currencies has not evaporated and trades continue to be cleared and settled efficiently.

Traditionally, many credit products have been traded over the counter rather than through organised exchanges. But over-the-counter markets generally lack transparency and the discipline of organised exchanges. Many credit derivatives and asset-backed securities also have non-standard features, making uniform analysis difficult and increasing the opacity of information about asset quality.

The opacity of these "dark pools" of liquidity (as some such "markets" are called) enables dealers to trade without having to reveal to the market the information implied by their trading. This may have contributed to the exponential growth of instruments such as credit derivatives, which grew from US$180 billion in 1996 to some US$55 trillion currently.

But when a financial crisis erupts, opacity becomes a serious problem, as little information would be available of the extent of concentration risk exposure in the market, participants would flee from trading, and a market failure would result.

It was recently reported that the US government is now considering creating a central clearing house for credit default swaps. This is a step in the right direction as it would potentially reduce counterparty settlement risk and free the logjam in credit markets.

For now, markets are suffering from a confidence crisis, so the immediate task is for regulators to restore confidence and stabilise markets. Still, in times of heightened uncertainty, what is needed for markets to function effectively is more transparency, not less. Fair-value accounting helps achieve this by delivering relevant information to investors.

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