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 no inherent constraints on buying and selling, 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.

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.

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 evidence and are determined using internal valuation models, hence the term ‘model’ model. An example would be asset-backed securities that are not actively traded.

Most issues in practical applications of fair-value accounting arise from (and at times Level 2) estimates. Such estimates are not precise but are 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 validate 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 the related movements and recognised fair-value changes, at each hierarchical level.

Traditional financial reporting involves three types of fair-value numbers:

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

- **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 currencies and equities has not evaporated and trades continue to be cleared and settled efficiently.

- **Liquidity:** Financial markets are also suffering a confidence crisis. The immediate task is for regulators to restore confidence and stabilise 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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