

Some Practical Issues in Applying Fair Value Accounting In Developing Markets



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Outline

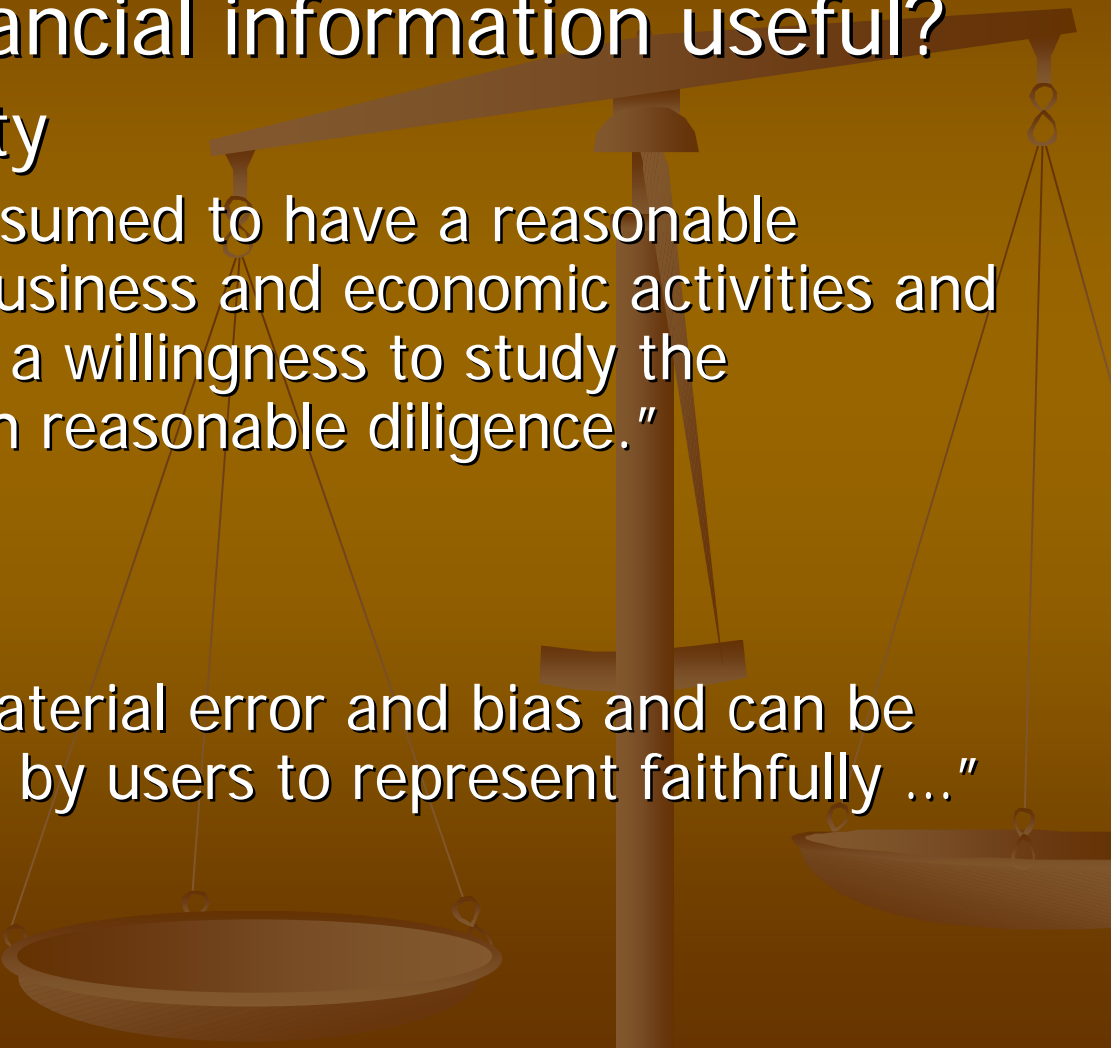
- IFRS Framework
- Fair Values
- Characteristics of Developing Markets
- Some Key Accounting Standards
- Practical Issues & Examples
- Conclusions



IFRS Framework (1)

- “The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.” [IASB Framework, Para 12]
- Users include shareholders, creditors, employees and the public at large [IFRS Preface]

IFRS Framework (2)

- What makes financial information useful?
 - Understandability
 - "... users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence."
 - Relevance
 - Reliability
 - "... free from material error and bias and can be depended upon by users to represent faithfully ..."
 - Comparability
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What is “Fair Value”?

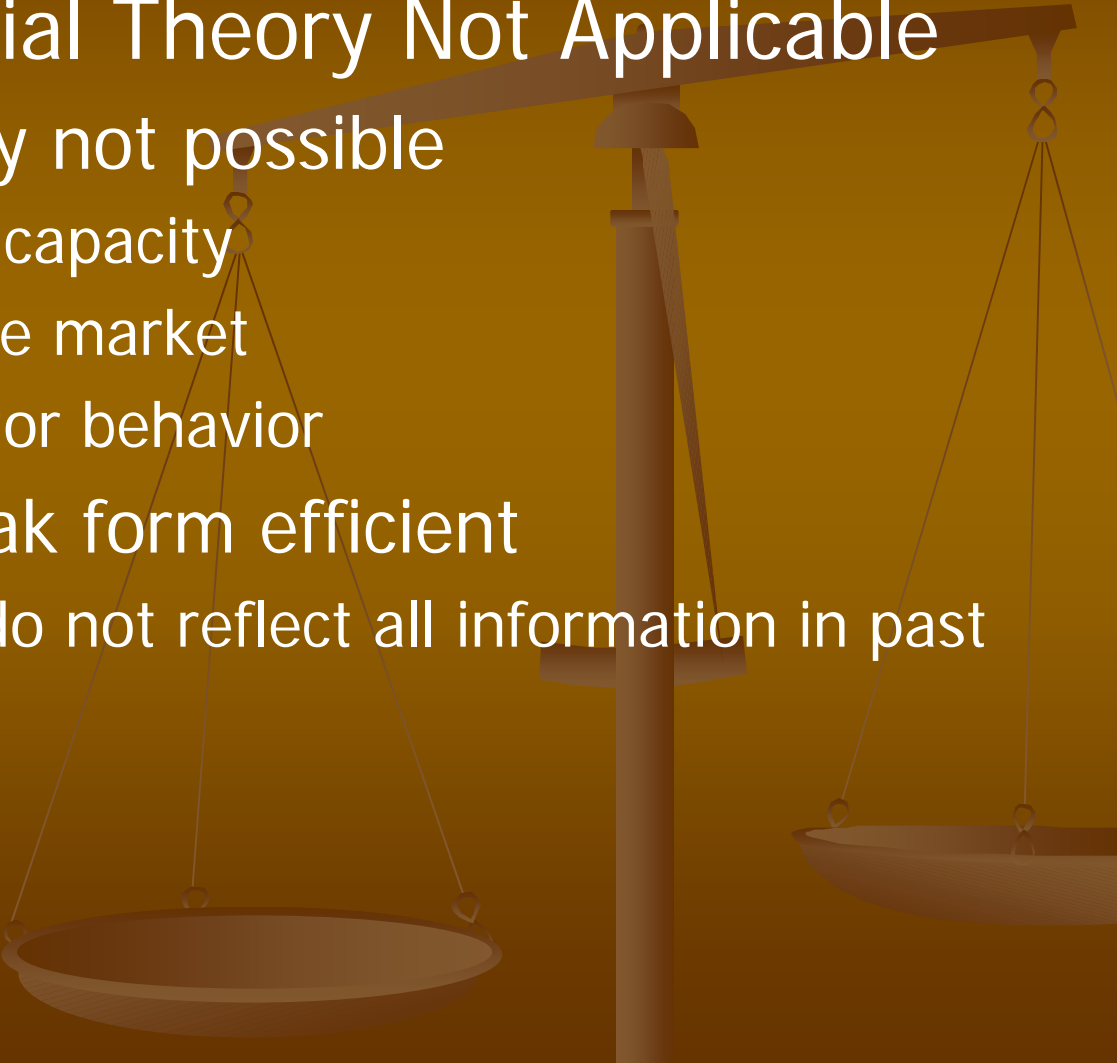
- “The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.” [IFRS 1 Definitions]
- Going concern presumption:
 - “Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale.” [IAS 39 AG69]

Characteristics of Developing Financial Markets

- Illiquid markets
 - Few listed securities
 - Low volumes relative to market capitalisation
 - Prices sensitive to very small trades
 - Institutional investors “buy and hold”
 - Large blocks held by small number of shareholders
 - Few market participants
- Significant information asymmetry
- Weak regulatory / institutional environment



Characteristics of Developing Financial Markets

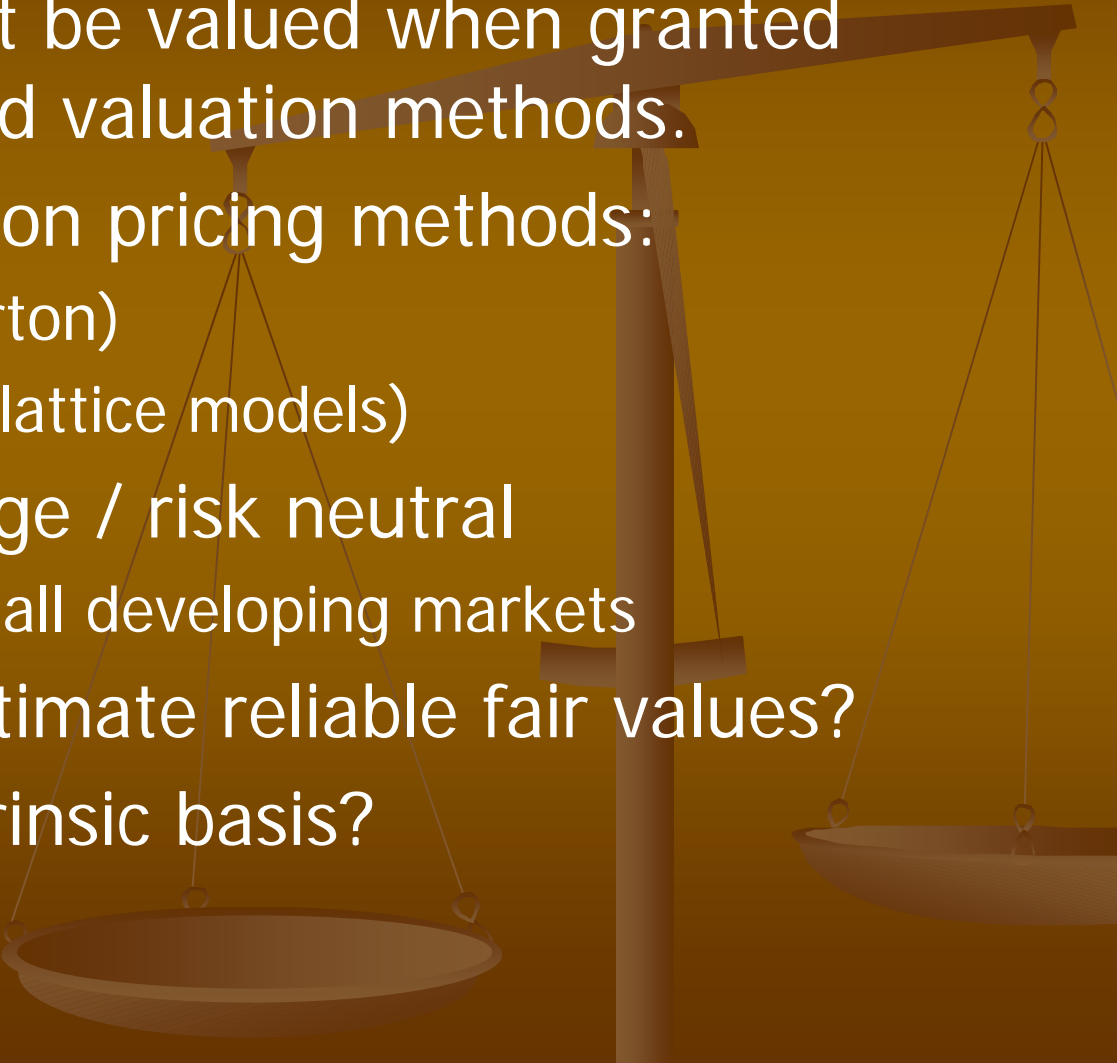
- Standard Financial Theory Not Applicable
 - Arbitrage usually not possible
 - Limited trading capacity
 - Cannot short the market
 - Irrational investor behavior
 - Markets not weak form efficient
 - Current prices do not reflect all information in past price history.
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Main Accounting Standards Affected By Fair Value Issues

- IFRS 2 – Share Based Payments
 - Valuation of stock options
 - IAS 19 – Employee Benefits
 - Discount rates
 - Fair value of pension plan assets
 - IAS 32 - Financial Instruments: Disclosure & Presentation
 - IAS 39 - Financial Instruments: Recognition & Measurement
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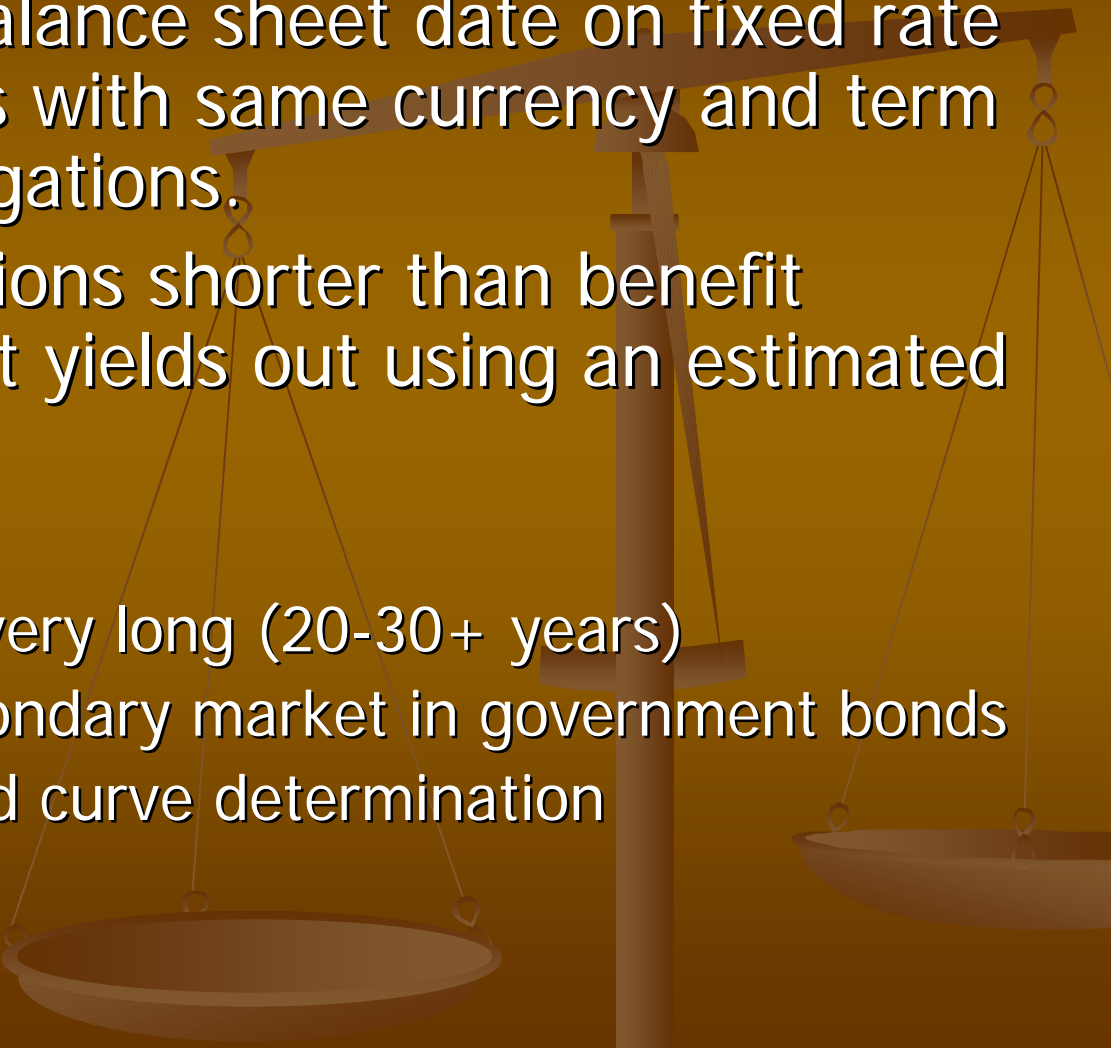
IFRS 2

Valuation of Stock Options

- Stock options must be valued when granted using market based valuation methods.
 - Most common option pricing methods:
 - Black Scholes (Merton)
 - Binomial Trees (& lattice models)
 - Assume no arbitrage / risk neutral
 - Not the case in small developing markets
 - Is it possible to estimate reliable fair values?
 - Account for on intrinsic basis?
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IAS 19

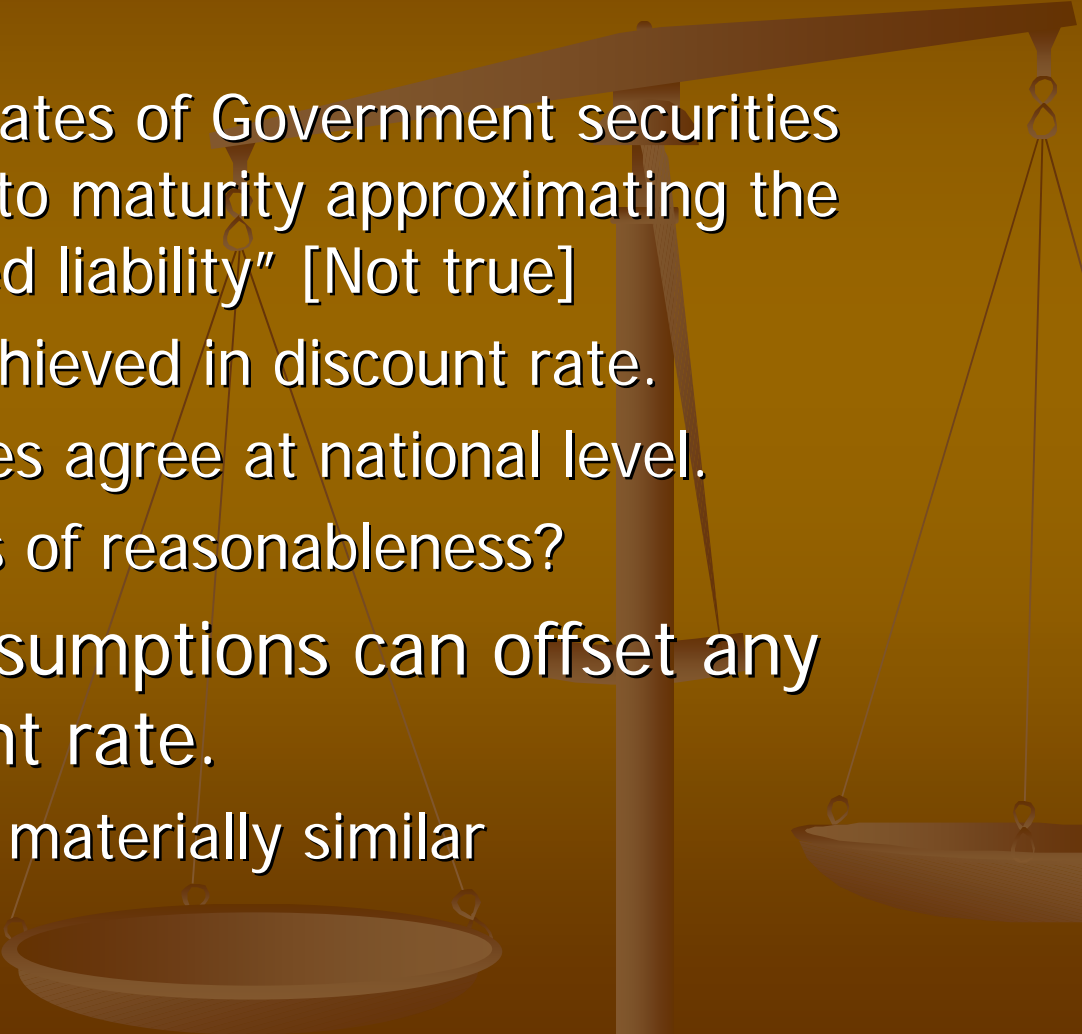
Discount Rates

- Market yields at balance sheet date on fixed rate government bonds with same currency and term as the benefit obligations.
 - Where bond durations shorter than benefit obligations, project yields out using an estimated yield curve.
 - Problems:
 - Pension liabilities very long (20-30+ years)
 - Limited active secondary market in government bonds
 - Subjectivity in yield curve determination
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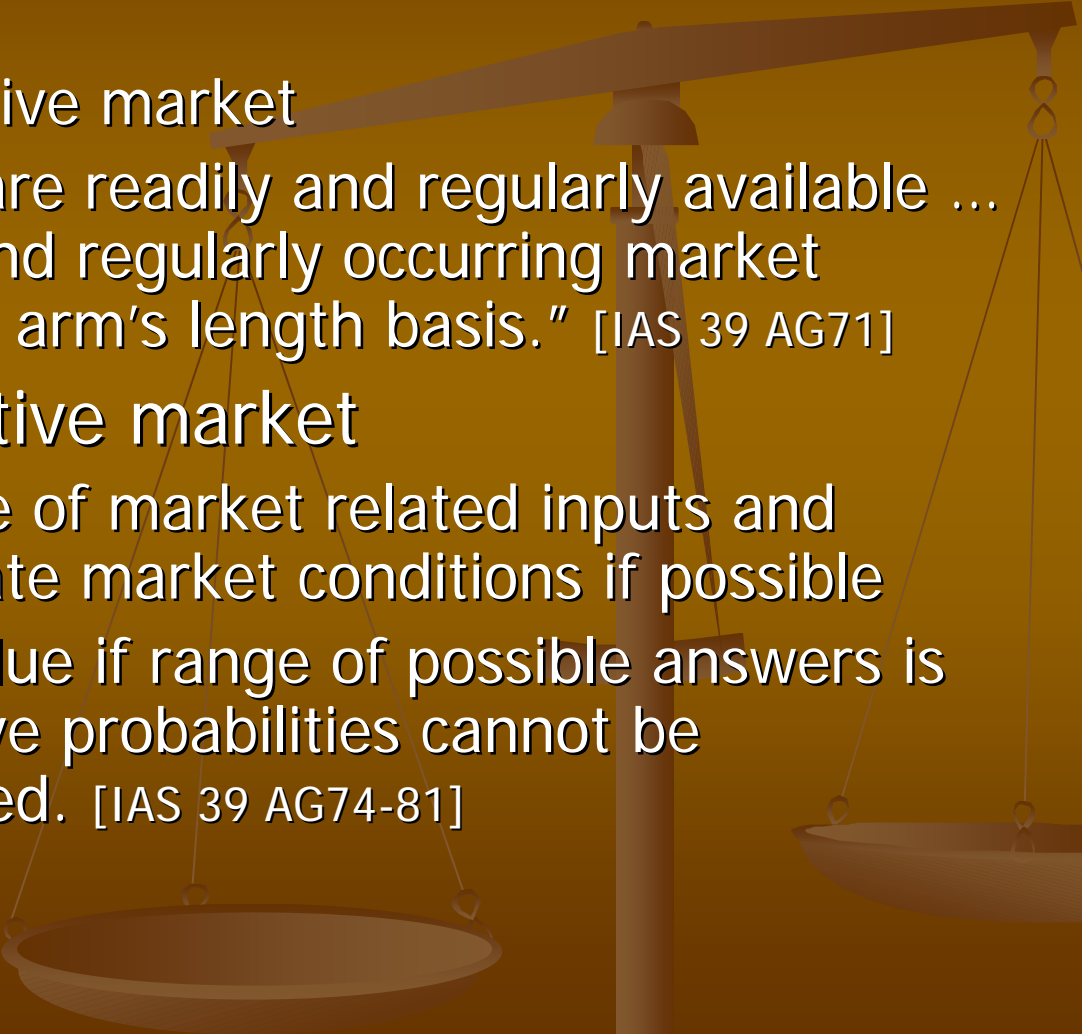
IAS 19 In Practice - Jamaica

	2004	2003
Govt Bond Yields (per CMMB)		
30 Year (Dec)	20%	28%
1 Year (Dec)	15%	23%
IAS 19 Discount Rates		
Grace Kennedy (Dec)	12.5%	15%
Sagicor (Dec)	12.5%	15%
FirstCarib Jamaica (Oct)	12.5%	14%
Jamaica Broilers (May)	12.5%	12.5%

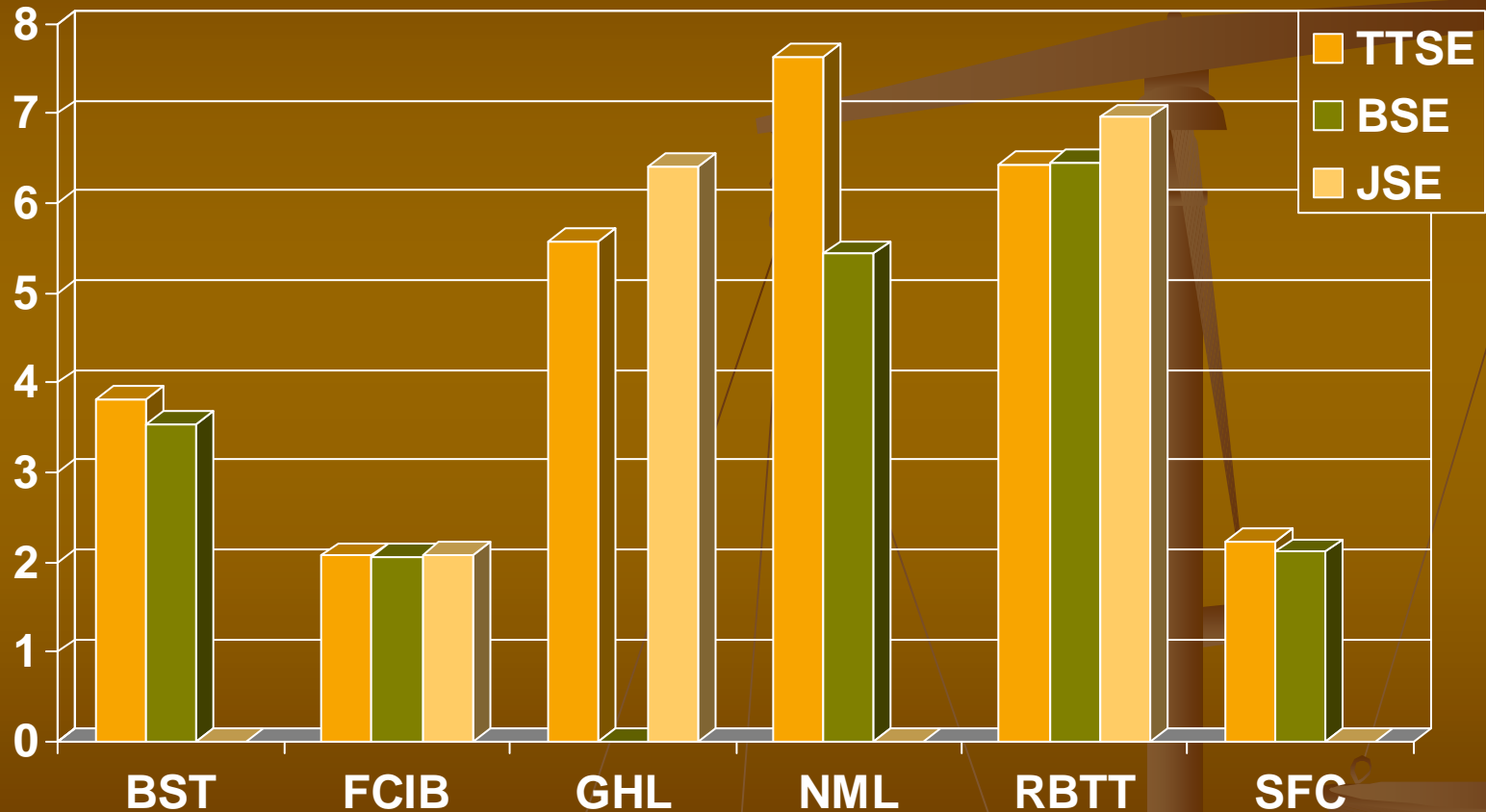
IAS 19 - In Practice

- Jamaica
 - "... using interest rates of Government securities which have terms to maturity approximating the terms of the related liability" [Not true]
 - But consistency achieved in discount rate.
 - Auditors & actuaries agree at national level.
 - Justifiable in terms of reasonableness?
 - Changing other assumptions can offset any changes in discount rate.
 - End result may be materially similar
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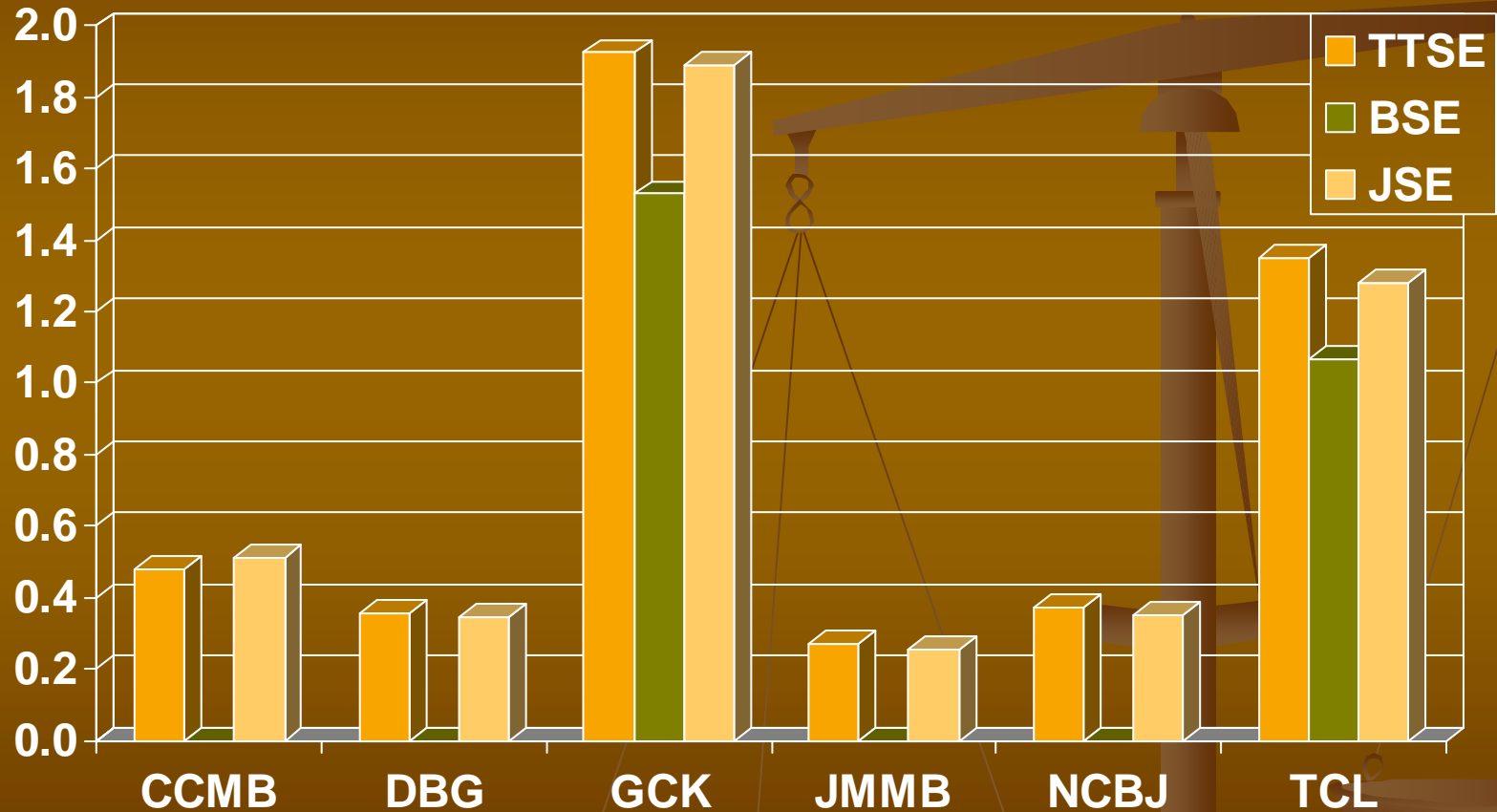
IAS 32 & 39 - Fair Value

- Market value
 - If quoted in an active market
 - "... quoted prices are readily and regularly available ... represent actual and regularly occurring market transactions on an arm's length basis." [IAS 39 AG71]
 - Valuation, if no active market
 - Must maximise use of market related inputs and models and replicate market conditions if possible
 - Cannot use fair value if range of possible answers is too wide, or relative probabilities cannot be reasonably assessed. [IAS 39 AG74-81]
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US\$ Stock Prices 31-Dec-2004



US\$ Stock Prices 31-Dec-2004



Conclusions

- IFRS & fair value requirements assume deep and efficient markets. Application in developing markets can be difficult. SME / Developing Economies project?
- Stock option valuation models assume weak form market efficiency and no arbitrage opportunities, both of which are not true for small developing markets. Unless market based models can be justified as unbiased and reasonable, the intrinsic method should be used.
- ICAC or local accounting bodies in conjunction with actuaries and other users should set parameters for IAS 19 calculations as is currently done in Jamaica. A similar approach could be used for the valuation of quoted instruments that are not actively traded.

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