Suruhanjaya Sekuriti
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S P E E C H E S

"Seminar on Fair Value Accounting and Its Implications on Financial Reporting Framework in Malaysia"

Keynote Address
by
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I would like to thank the Malaysian Accounting Standards Board (MASB), the Malaysian Institute of Accountants (MIA) and the Malaysian Association of Certified Public Accountants (MACPA) for inviting me to speak at this seminar.

I would like to devote my time this morning discussing issues relating to fair value accounting particularly in the context of financial instruments.

Fair value accounting gained significant prominence over the years principally by the problem in measuring financial instruments. Financial instruments, which include derivatives, have become a cornerstone of modern finance. They are used by companies in capital formation, to reduce cost of financing, to improve portfolio returns and reduce risk and to hedge and change the risk-reward profile of investments. Increasingly, companies are exposed to financial instruments in one form or another. As a result, financial volatility has become a feature of many companies' operating environment. It is, therefore, not surprising that users of financial statements clamor for information that would provide them with an understanding of how companies would likely be affected by changes in interest rates, currency exchange rates, equity prices or commodity prices.

Ladies and Gentlemen:

The fundamental premise behind financial reporting has always been to provide useful information about the financial position, results of operations and cash flows of a company to users of financial statements so as to facilitate informed decision making. As you are no doubt aware, in times of fluctuating markets and uncertain economic climates, transparency, and financial reporting quality take on an even greater importance. It is, therefore, imperative that the financial reporting framework and the resulting disclosures reflect on a timely basis, the underlying economics of transactions entered into by companies so that users of financial statements are cognizant of the risks these companies are exposed to and the manner in which they manage them.

Growing globalisation of markets, increasing government deregulation, the development of more extensive and deeper markets for financial instruments, increased volatility in prices and the growth of active risk management practices have driven a wedge into the heart of historical cost.

Ladies and Gentlemen:

We are all well aware of the many instances where derivatives trading has contributed to the severe losses incurred by large and established companies, much to the horror and surprise of investors and other users of financial statements. In 1994, for example Procter & Gamble lost USD157 million resulting from their unsuccessful use of swaptions (options that relate to interest rate swaps).The company recognised the losses and disclosed the facts only when the transaction was closed. The collapse of Britain's Barings Bank is another example.

It became obvious that the conventional historical based accounting does not provide meaningful information. It does not produce timely information about the performance of trading activities of a business enterprise and any of the associated risks.

As a result, regulators and users of financial statements increasingly view historical cost as a dangerously static basis of valuation, especially for entities exposed to financial instruments. The inherent nature of financial instruments, particularly derivatives, unlike other assets has prices that can become very volatile and can at times be very unpredictable. The assessment of the instrument's risk becomes almost impossible based on the current accounting measurement model.

It is within this setting that " standard-setters" worldwide have relentlessly pursued the conceptual framework objective of decision-usefulness and advocated fair value as more relevant.

In today's dynamic and volatile markets, whether it is to buy or sell, what people want to know is what an asset is worth today. Accounting research supports this assertion. Standard setters in the US, UK, Australia and the International Accounting Standards Board are committed to eventually measure all financial instruments at fair value. Fair value measurements provide more transparency than historical cost based measurements. Fair value measurements ensure that balance sheets report derivatives as " on" rather than " off" balance sheet. Fair value measurement provides more transparency and management's accountability of the firm's business. Fair value accounting also will promote better risk management policies within a company and add to the development of better risk management tools.

If companies in Asia had measured and disclosed all financial instruments at fair value, regulators, depositors, investors and other users of financial statements could have achieved greater regulatory and market discipline and avoided some of the losses that investors and taxpayers have had to pay during previous 1997-98 economic crisis.

Ladies and Gentlemen,

The advantage of using fair value rests in its relevance and reliability over historical cost. Reliability is as important as relevance because relevant information, which is not reliable, is useless to a financial statement user. IAS 39 has defined fair value to be the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's-length transaction. Fair value has often been associated with market value. However, difficulties arise when there are no active markets to determine the price of the instrument. Therefore, where quoted market prices are available, fair value can be reliably determined. In the absence of quoted market prices, good estimates of fair value will have to be made.

This issue is pertinent to Malaysia and other developing countries, where observable market prices are not always available. Additionally, the trading market for financial instruments such as derivatives and bonds are still at a nascent stage. There are no deep, liquid and mature markets for these financial instruments, unlike in the United States. It has been argued that it will therefore be difficult to apply fair value accounting and that standard-setters may have to contend for now with a hybrid approach of historical cost and fair value accounting.

Existing accounting models on financial instruments prescribe for some financial assets and liabilities to be measured at historical cost while requiring others to be valued at fair value. To add to the mix, for those measured at fair value, the resulting change of valuation is sometimes recognised in the income statement while at other times recognised as part of equity. The classification of financial assets and liabilities will be based on management intent and view, which can result in the same financial asset to be recognised differently by companies.

Nevertheless, given that we are pushing ahead, I am pleased to note that the MASB and the accounting profession are examining these issues in depth and have taken a pragmatic approach in recognizing that there are issues to be resolved and have, therefore, wisely elected to adopt fair value accounting in phases.

As an initial initiative, MASB has issued a standard on the disclosure and presentation of financial instruments. This level of disclosure would at least allow market participants to evaluate the risks associated with financial instruments. However, increased disclosure does not in itself serve as a panacea. The recognition and measurement of financial instruments cannot be sidelined for too long a period, as it would be difficult for users to gauge the company's financial position solely by relying on disclosures. Arising from this, MASB together with the accounting profession are studying ways in which IAS 39 - Financial Instruments: Recognition and Measurement, may be adopted in Malaysia to require more transparency of financial instruments transactions in the financial statements of companies.

Given time and with efforts channeled to enhancing accounting and valuation guidance for fair value measurements through educational seminars and the like, I am confident that eventually we will be able build a framework that will allow for reliable measurements that are faithful to the economics of the underlying transactions in the market place.

Companies must also be cognizant that the adoption of fair value accounting may also entail significant cost and time. The cost could encompass expenses for the increase of staff, the procurement or installation of new software systems, valuation costs, advisory costs, training and education costs and other relevant costs.

As entities begin to tackle their accounting systems, it will be a natural progression for valuation techniques, auditing techniques and internal control systems to evolve to cater for the changes. In the interim there may be a lack of skill among accountants, auditors or other professionals. Users may not be able to value the information provided because they lack experience and understanding of the concept.

Nevertheless, as a way forward, the Malaysian market cannot afford to ignore these developments in financial reporting. There are no simple solutions to these issues, but I hope, that this will not deter you from joining efforts in overcoming these issues to reach a common goal of providing more useful and relevant financial statements.

If we ignore fair value accounting it would mean that Malaysia is moving backwards in financial reporting. We must not allow these issues to prevent us from pursuing a bigger objective that is to provide high quality, useful and relevant financial information for the users of financial statements.

Finally, it serves to be reminded that potential investors will be willing to pay a premium for increased disclosure and quality financial information which essentially translate into increased investor confidence, improved shareholder value and the enhancement of Malaysia's competitive edge.

With that ladies and gentlemen, I wish you a fruitful day ahead.

Thank you for your attention.

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