

### Box 3

#### Introduction to fair value accounting standards

##### *1. The definition of fair value*

According to International Accounting Standards No. 32 (IAS 32) and Taiwan's Statement of Financial Accounting Standards No. 36 (Taiwan's SFAS 36), "Financial Instruments: Disclosure and Presentation," fair value represents the amount for which an asset could be exchanged and a liability could be settled in an arm's-length, orderly transaction between knowledgeable and willing parties. IAS 39 and Taiwan's SFAS 34 "Financial Instruments: Recognition and Measurement" have further mandated that quoted market prices in an active market are strong evidence of fair values. If the markets for financial instruments are not active, however, valuation methodologies may be employed. The acceptable methodologies include the prices generated by recent market transactions (or referring to the current fair value of another instrument that is substantially the same), discounted cash flow analysis, and option pricing models.

Moreover, in order to improve the consistency and comparability of fair value measurements and disclosures, the US released SFAS 157 in 2006, which clearly specified that fair value is, at measurement date, the price to be received or paid in an orderly transaction between market participants when selling the asset or transferring the liability. Based on the prioritization of inputs used to measure fair value, the statement established a hierarchy of fair value methodologies, which comprised three levels:

- Level 1: financial instruments with observable, quoted prices in active markets should be measured at the quoted prices. This level carries the best quality of fair value information.
- Level 2: those financial instruments with observable inputs for identical or similar assets or liabilities in markets (e.g. infrequently traded corporate bonds or government bonds that have no quoted prices or trade infrequently, but can be referred to market values of similar securities) should measure their fair values by introducing the observable inputs into the models.
- Level 3: for financial instruments with unobservable inputs for the assets or liabilities (e.g. asset-backed securities), fair values can be measured based on the assumptions, made by the reporting entity, with the best information available (which may include the reporting entity's own data) and are estimated by mathematical valuation models.

## 2. Pros and cons of fair value accounting

| <i>pros</i>   | <i>cons</i>   |
|---|---|
| <p><b><i>Fair value is more predictable</i></b></p> <p>A fair value of financial instruments represents market expectations and assessments as to the amount, time, and uncertainties of such instruments' future cash flows. It takes elements that affect market values, such as interest rates, exchange rates, credit, and demand and supply into consideration. Hence it is more predictable.</p> <p><b><i>Increasing comparability among financial instruments with similar economic characteristics</i></b></p> <p>Fair value information normally reflects judgments on the current value of expected future cash flows for related financial instruments in the financial market, which allows comparability among financial instruments with similar economic characteristics.</p> <p><b><i>Consistency with approaches of financial risk management and beneficial to performance evaluations</i></b></p> <p>Fair values reflect the latest values of financial instruments. This accounting</p> | <p><b><i>Reliability of fair value measurements is relatively low</i></b></p> <p>Financial instruments without market prices, due to an inactive market or exhausted liquidity, should be valued by models. However, the high uncertainty on the parameters, hypothesis and estimation deviations introduced by valuation models, and the lack of definite measurement indicators for evaluation calibrations have raised concerns about the reliability of fair value measurements.</p> <p><b><i>Lack of comparability of financial statements among peers</i></b></p> <p>The classifications of financial instruments in fair value accounting standards are based on corporate intentions and capabilities. As a result, various corporations who hold similar financial instruments will have inconsistent bases for subsequent measurements owing to the classification differences. This could undermine the comparability of financial statements among peers.</p> |

approach helps to set and control stop-loss limits for financial risk managements, and evaluate the corporate internal performance. It is also beneficial for external financial statement users to objectively evaluate the performance of corporations.

***Financial reports are presented more fairly***

Financial derivatives are generally off balance sheet transactions. As fair value accounting standards require corporations to recognize effects of changes in fair value in order to reflect off balance sheet risks on time, the financial reports can be presented more fairly.

***Increasing the volatility in the financial statements and enhancing effects of procyclicality***

The volatility in the financial statements with fair value measurements will be increased when unrealized profits or losses are instantly recognized on income statements or balance sheets. Also, if corporations distribute surplus to shareholders based on the unrealized gains from assets revaluations or from liability reductions, their financial structures will be impaired. Moreover, fair value accounting is mainly applicable to the measurement of financial assets, while most financial liabilities are recognized at amortized costs. The inconsistent accounting approaches between financial assets and liabilities will lead to a procyclical effect. For example, during economic recessions, fair value measurements will enable a drastic reduction of corporate values and even trigger the contagion effect.

***Measurements of fair value can be manipulated easily***

As market values of financial instruments are easily manipulated, fair value may fail to reflect the real values. This could erode the quality of financial statement information.