# Fair-value accounting's blind spot

**In recent years, the preference for market-determined prices as the correct basis for valuation has become deeply ingrained. While agreeing with this view in principle, David Rowe argues it is not applicable in all circumstances**

Arguments over the proper basis for valuation seem as old as recorded history. Until comparatively recently, they were deeply entangled with ethics and religion. Today, in most parts of the world, the 'right' price is understood to be that which balances quantities supplied and demanded in open and competitive markets. Over the past 30 years, accounting standards have shifted from the purported objectivity of amortised historical cost to embrace mark-to-market pricing. While I am broadly supportive of this trend, it can be taken too far.

One essential distinction in the discussion of market-based prices is between stocks and flows. Traditional supply-and-demand analysis applies to goods and services that are manifested in a recurring flow of production and consumption. When demand for a product rises – for example, when a particular vegetable is discovered to have stupendous health benefits – suppliers cannot immediately increase production at the existing price. As a result the price rises. This reduces the quantity demanded in the short run and, in the longer term, encourages greater supply.

David Rowe is senior strategist for risk and regulation at Misys in London. Email: david.rowe@misys.com

Now move from flows to stocks and consider a producer holding inventories of the product in question. It is sensible to 'write up' the value of those inventories immediately to the higher market price, especially if the producer is relatively small and could expect to sell its stock at something close to this new price.

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So far, the above is little more than basic microeconomics. The issue becomes more complex, however, when we turn to financial assets such as common shares or bonds. Such items exist as a large stock that is either fixed or changes only slowly in fits and starts, as when new shares or bonds are issued, shares are bought back or bonds mature. In this case, the prevailing price is the one at which investors are just willing to hold the outstanding available stock of securities. At this price, those holding the securities feel they are worth the prevailing price or more and are unwilling to sell. Those who do not hold the securities feel they are worth the prevailing price or less and are unwilling to buy.

When sentiment changes in this type of market, the entire reaction must be absorbed by the price – as was the case when demand for mortgage-backed securities collapsed in the first phase of the crisis. The total volume of the securities remains unchanged and they all have to be held by someone.

The awkward question is whether applying the price of a marginal transaction to all the outstanding units of a security results in a sensible total value. If an investor wants to buy all of a firm's outstanding shares, the total cost would be higher than that implied by the price of a marginal transaction, while an attempt by existing investors to sell all their shares quickly would realise a far lower value. The key lesson is that the value of the total outstanding stock of a security depends heavily on the timeframe over which its value is to be realised.

The problem of distorted total valuation is compounded by the fact that accounting reports are not external to the market supply-and-demand process. The sudden marking down of a firm's assets can create accounting losses that intensify a pessimistic market view, leading to a reinforcing feedback loop.

As we were reminded repeatedly during the financial crisis, banking is a business built on confidence. When confidence is shaken, market reaction can significantly magnify the damage caused by these events themselves. In today's world of 24-hour news and instant global communication, self-reinforcing waves of optimism and pessimism can spread with alarming speed, and mark-to-market accounting can reinforce such feedback.

Fair-value accounting has provided many benefits in the form of more rational pricing of credit risk, but we need to beware of unintended consequences. Looking back at the worst of the financial crisis in the cold light of morning, the ugly duckling we call a mixed-attribute accounting model begins to look more like a beautiful swan than I ever imagined. **R**