APPENDIX IV

Challenges the Emerging Market Economies May Encounter in the Application of Fair Value Measurement According to the Exposure Draft

As is indicated in the body of the draft proposal, the AOSSG holds that the Board should provide guidance on how fair value measurement shall be applied in emerging market economies. The Board in providing guidance for the emerging markets should consider the following problems that may occur to emerging markets:

I. Emerging markets may see relatively low quality inputs of fair value measurement.

The quality of the inputs of fair value measurement available from emerging markets may be lower than that from the developed markets. We noted the following two scenarios:

1. The market may undertake more functions beyond pricing, such as development.

The primary function of a market is pricing. Fair value measurement carried out in accordance with the exposure draft actually tries to reflect or simulate the results of market pricing, which is highly dependent on the inputs from the market. However, as the emerging market economies are generally in the process of improving the market mechanism, their fair value measurement inputs from markets are often tend to exhibit more results than pricing. If we rely on the those inputs from emerging markets as we do to developed markets, it may reduce the quality of accounting information achieved by fair value measurement.

Example 1 China’s futures market

An original intention of China’s futures market was to introduce the prices of certain commodities from international markets as a part of price reform in China. At that time, China's price system was at a transitional stage called double-track pricing system, namely from government pricing to market pricing, where the prices of some commodities, such as certain petrochemical products, had never been free from government pricing before.

2. Market prices are subject to higher volatility.

The price volatility in an emerging market is higher than that in a mature market. In such circumstances, fair value based on market inputs may reduce the decision-making usefulness of financial statements to users. Namely, users in decision-making may be forced to seek other information to fix the reported fair value, which is not conducive to improving the quality of financial reporting. Decisions made by market participants based on the reported fair value may further reduce the quality of fair value measurement inputs from the market system.

Example 2: China's stock index volatility in the period from 2007 to 2008

The Shanghai composite stock index reached a record high point of 6124 on 16 October 2007, and fell to 1665 on 28 October 2008. The Dow Jones 500 index at these two dates stood at respectively 13992 and 8175, while FTSE 100 respectively 6645 and 3848. Many investors and analysts in Chinese market complained that the investment value at the peaks and troughs exhibited in financial statements was not its true value, drastically impacted the decision-making usefulness of financial statements.

II. There are insufficient methods and conditions to apply fair value measurement.

In addition to the possibly indecent quality of inputs of fair value measurement, the financial reporting entities in emerging market economies are lacking methods and conditions to use fair value measurement, which is likely to further endanger the decision-making usefulness of fair value on these markets. We noted the following two scenarios:

1. Given a young and shallow capital market, consequently there is no available method or key inputs in line with the requirements of fair value measurement.

Example 3 Investment in equity of a private company
Company A holds an industrial investment in an private companie's equity with a historical cost of about RMB 30 million, while the equity of company is non-tradable. Moreover, Company A can not measure its fair value through unobservable inputs, such as management judgment.

2. The use of fair value measurement in emerging markets is challenged by undue cost and lacking of qualified and experienced accountants.

Example 4: Fair value measurement of investment properties in China

The use of fair value in measuring investment properties was stipulated in the ASBE since 2007. However, we noted that in annual financial reports of 2007, among 630 listed companies who have real estate investment, most companies use cost method to measure their investment properties while only 18 listed companies implement the subsequent fair value measurement. Analysts believed that this is due to undue costs resulting from fair value measurement and lacking of qualified and experienced accountants.

III. The fair value measurement and the market infrastructures need coordinated improvements, which means an arduous mission to accounting standard setters.

In emerging market economies, progress in accounting standards and in market infrastructures are often interwoven, while the improvement of regulation and supervision often lags behind that of accounting standards, which may lead to improved accounting standards and unimproved quality of financial reporting, and may sometimes result in conflicting regulatory and supervisory rules and accounting standards. These problems are often similar to the first aspect (the quality of inputs) while more directly linked to improvement of regulation and market infrastructures. Here we give two examples:

Example 5: Determination of closing price and enhancement of the quality of observable inputs

A is a financial product actively traded on a market. In accordance with the requirements of certain regulators and the exchange, its closing price on each trading day is to be modified from the weighted average of all transaction prices in the last 10 minutes to the weighted average of all transaction prices in the last hour so as to prevent its closing price from being deliberately driven up or pulled down at the end of every trading day. Regardless of whether the regulators and the exchange will improve the method for calculating the closing price, fair value measurement of A in financial reporting shall be based on the closing price. Obviously, the way to determine the closing price is significantly related to the decision-making usefulness of fair value information in financial reports, while generally speaking accounting standard-setters can not determine the improvement of regulatory rules or of market infrastructure.

Example 6: The discount rate of non-tradable shares, which is a legacy of history

In the restructuring and listing process of China's state-owned enterprises C, non-tradable shares held by company B come into being. Therefore, the fair value of these non-tradable shares shall be discounted to the price of C's tradable shares in company B’s financial reports. In history, the discount varies significantly in empirical research ranging from 6% to 86%. Financial reporting entities as well as analysts are often confused about whether this discount rate shall be regarded as level 2 inputs or level 3 inputs if the fair value is measured under the exposure draft.