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What Is An Asset Really Worth?

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SMU Associate Professor Jeffrey Ng investigates how fair value estimates are derived and what determines how investors respond to them.

AsianScientist (Oct. 7, 2014) – By Rebecca Tan – Although fluctuations in the stock market might appear random, they are in fact the result of individual investors trying to maximise their rate of returns. These investment decisions, or ‘bets’ as they are informally called, are often based on information supplied by the company or by independent analysts.

In his research, Associate Professor Jeffrey Ng from the SMU School of Accounting studies how capital markets respond to information. During his PhD research at the Wharton School of the University of Pennsylvania, he focused on how the quality of a firm’s information affected its liquidity risk.

“A simple way of thinking about liquidity risk is the risk of investors’ flight from a stock when the liquidity in the stock market drops,” he explains. “In my thesis, I found that the better the quality of information supplied by the firm, the lesser panic there is in the capital markets when liquidity dries up.”

In his subsequent research, Professor Ng deepened his expertise by focusing on the banking sector. Out of all the information provided by banks, one type of information struck him as especially important and became his current research interest: fair valuation.

“My interest in banks was spurred both by the financial crisis as well as my stint at the Monetary Authority of Singapore as a bank auditor before I started my PhD programme,” he shares. “In particular, I have been working on topics related to fair valuation, which typically affects banks more than other types of firms because banks have the largest amount of assets that are recorded at fair value, such as derivatives and financial instruments.”

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How do investors see fair valuation?

Fair valuation is the price that a person would get if he or she sold an item today, in contrast to what it originally cost the person in the past. Take for example a property that was bought four years ago at the price of $500,000 and sold today for $800,000. The historical price would be $500,000 while the fair valuation is $800,000.

“Some time ago, many items in a company’s financial statements were reported at historical costs. However, as you might imagine, fair value is a lot more relevant for decision making. Because of this, there is now a move towards recording a company’s assets at fair value. In fact, the two major standard setting bodies in the world—the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB)—have been working on harmonising standards related to fair value accounting, in addition to promoting new standards that encourage more fair valuation,” Professor Ng says.

“Here in Singapore, accountants have been urged by the Minister of State for Trade and Industry Mr Teo Ser Luck to offer more high-value corporate advisory services, including business valuation and risk management, which require fair valuation.”

Despite the growing impetus for fair valuation, the process of deriving a fair valuation estimate is not without inherent limitations, Professor Ng says. Firstly, fair valuation estimates are volatile, especially for assets such as stocks. This volatility creates a concern about the lack of reliability of the information found in financial statements. A second limitation is the issue of subjectivity. While assets such as stocks can be estimated quite accurately by looking at the stock market, fair valuation becomes more complicated when dealing with assets which are traded less frequently, and therefore, are evaluated more subjectively.

“For example, the value of a property could depend on factors such as the availability of an MRT station nearby. However, the weightage that each factor receives is subjective. It may be more important to you to have an MRT nearby but not to a person who drives a car. As a result, you end up with two different fair values,” he adds.

Taken together, volatility and subjectivity ultimately lead investors to discount fair value estimates in their decision making processes. In his research, Professor Ng has found that the amount of discounting that investors applied was higher during times of uncertainty such as the 2008 global financial crisis, but it abated as the economy recovered.

“While it is well recognised that fair valuation is a complicated process that generates a lot of reliability concerns, my research highlights the need for a better understanding of the production, delivery and receipt of fair value information,” he says.

Towards cross-country and interdisciplinary research

In order to address this need, Professor Ng has initiated a study on cross-country differences in fair valuation estimates, together with colleagues from the SMU School of Accounting, namely Assistant Professor Kevin Ow Yong Keng, Associate Professor Gary Pan and Associate Professor Lim Chu Yeong.

“Specifically, we will be looking at whether cross-country differences affect the valuation, preparation and acceptability of fair value estimates. For example, in countries that are considered more corrupt, is there greater discounting of fair values in financial statements? You would expect more discounting in perhaps Cambodia versus Singapore, because there is less trust in fair value numbers. Furthermore, there are fewer established ways of determining fair value in developing economies, hence making it trickier,” he says.

“Our study would involve collecting financial statement numbers from other countries, and doing standard empirical analyses to see whether variations in discounting depend on, for example, the perceived level of corruption. We are also hoping to carry out interviews with academics and practitioners about their concerns and the methods they use.”

The interdisciplinary study of capital markets is another field of research that Professor Ng predicts will be fruitful, especially as traditional disciplines become more saturated. He notes that capital market research has historically tended to ignore the behavioural side of investors, considering it to be homogenous and unable to affect the stock markets. However, literature from psychology now suggests that investors may suffer from some level of investor inattention, with real repercussions on the capital markets.

“I hope to see more collaborations between faculty members from both the research and practice tracks because such collaborations might result in research that has more implications outside academia,” he says.

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