

<b>PROCYCLICALITY AND ACCOUNTING STANDARDS</b> <b>Fair value accounting and standard-setting process</b>
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NOV 2008

## EXECUTIVE SUMMARY

The IFRS have brought an opportunity to modernize and unify accounting standards in the EU, and introduced sophisticated standards that were lacking to account for complex financial instruments that had emerged precisely in the 1980's when IFRS were devised. More transparency has been achieved at the same time. Therefore, the purpose of this paper is not to call fair value accounting into question, in order to go back to historical cost accounting. Fair value accounting, however, is producing highly undesirable effects, some of them having materialized at the height of the present financial crisis, triggering what many observers called a "vicious circle". Some emergency measures have been taken to address the extreme situation reached in a context of illiquid markets. But the turmoil evidenced fundamental issues about fair value accounting and its so-called "pro-cyclical" nature, even in normal circumstances, which need to be addressed. That includes the need for modifications to accounting standards to limit the impact of fair-value accounting as well as, with the same objective, to the standard-setting process in the interest of investors as well as all other stakeholders.

### I- Analysis

Fair value accounting produces undesirable effects on companies' accounts, on markets and on the economy. **Market volatility is imported in companies' accounts and propagated to all actors, at a far higher level than the volatility or the amplitude of the business cycles in the "real economy", thus questioning whether it really delivers a true and fair view of the performance of firms, and whether so many management critical decisions can be made on that basis.**

More precisely, the *pro-cyclical effects* can be analysed as follows:

- fair value accounting creates a "volatility effect": the volatility of markets is "imported" in the firm's accounts, no matter whether it has a link with its actual performance, as a "going concern", and no matter whether the last transaction, fixing the price of the whole stocks of fair-valued assets or liabilities, is marginal. To mention one example, a company selling goods around the globe in various currencies cannot hedge its future backlog by using financial instruments, as would be prudent management from an economic standpoint, without "importing" in its own accounts the volatility of the financial markets, blurring the difference between its performance as a seller of manufactured goods and the variation of the instant price of financial instruments;
- fair value accounting has a "mismanagement" effect: strategic management decisions are increasingly made on the basis of instant market prices, which prove to be volatile and reversible, depending on market conditions; investment projects, restructuring plans, incentive policy, dividend policy or any other management decision made on this basis are subject to the same risk of error, by relying on current market conditions to take medium or long term decisions. Of course all such decisions obviously affect all reactions of stakeholders of all kind, and their own strategic decisions, thus defusing a pro-cyclical effect to the markets and the economy more widely;
- fair value accounting has also a "misleading" or "accommodating" effect during the formation of a bubble. In this critical moment indeed, fair value accounting will show a deviation in prices but will not prevent participants from riding the bubble because it is profitable to all of them at the same time: investors see the value of their portfolio grow, the management see their bonuses sky-rocket and institutions enjoy higher returns. This is why, contrary to what is often argued, *not only does fair value accounting not reveal actual gains or losses in due time before the bubble builds up, but during the development of a bubble, it is inherently pro-cyclical*. Bubbles happen for many reasons which are not linked to accounting, but fair value accounting is not preventing bubbles: on the contrary, it is hiding or even encouraging them until they burst;
- the "trap" effect of fair value accounting is best known as it was experienced in the financial turmoil: it means the impossibility to use mark-to-market accounting when markets are not functioning, in

times of crisis or for any other reason. One can consider that fair value accounting accelerated a large number of distressed sales and losses which could possibly have been avoided, therefore exacerbating the financial crisis.

*These undesirable effects are due to an increasing reliance on the use of mark-to-market valuation, as an overarching goal, without enough consideration given to management needs, actual investors needs, or financial stability. All these issues are critical, even beyond the specific problems arising in times of crisis, since the IASB seems to be leaning towards greater use of market values, to the risk of amplifying all drawbacks of fair value accounting and its impact on the economy.*

## **II- Proposals**

- In the wake of the crisis, it would only be reasonable to explicitly decide that **no standard should result in a further move towards more, or obviously full fair value accounting.**
- **A large conceptual debate should take place about the ways to account for medium term economic value creation.** As opposed to a mere confrontation between “historical cost” and “fair value” accounting or “model” accounting, more interesting results could be achieved by focussing accounting on medium term “real” business models and activities, instead of instant market measurement. This could be conceptually documented and would finally lead to move from “fair value accounting” to “economic accounting”.
- **A discussion could also take place about some very significant issues** that need to be addressed for practical purposes, **like accounting for derivatives and for hedging strategies,** with a view to better taking into account the real needs and strategies of firms.
- More urgently, some problems need to be fixed without delay: beyond the changes made to IAS 39 and IFRS 7 in October, in order to allow the reclassification of illiquid assets from the “trading book” to the “banking book”, a number of issues relating to financial instruments’ accounting remains.
- **Another area for progress concerns the link between performance reporting in the statement of income and assets and liabilities valuation rules in the balance sheet.** That is part of the convergence project called “Presentation of the financial statements”, currently underway.
- **A critical issue relates to the combination of accounting and prudential standards.** From a financial stability - as well as practical - standpoint, there is an absolute need to **ensure that accounting standards do not diverge from prudential standards,** to the risk of creating inconsistency, at times when we need, on the contrary, more coherence in both systems. More generally, accounting standards should not become so “esoteric” and so specific – as is the case if mark-to-market is the only measure of value, not reflecting the economic reality outside – that they could not be used directly without so many “filters”, adjuncts or necessary recalculation and be relied upon by any of the relevant concerned parties, management, market participants as well as supervisors.
- In the same vein, studies about ways to accommodate “dynamic provisioning” in the IFRS would also be useful and contribute to the efforts of reducing procyclicality.
- Eventually **the standard-setting process should be more closely linked to the medium and long term economy goals and not only serve the short term needs of the financial world:** accounting rules are not neutral, they reflect a conceptual approach of the economic world. Present IASB and FASB conceptual choices are favouring more and more volatility and a short term vision of the economy. It is surprising to note that the IASB and FASB conceptual Frameworks have not yet been thoroughly discussed and revised whereas most new standards issued are implementing deep conceptual changes, which have never been debated in Europe or in the United States, like full fair value accounting or comprehensive income. **Involvement of public authorities and economic actors in the definition of the accounting conceptual framework is a key factor** to insure adequacy and relevance of accounting standards.

## PROCYCLICALITY AND ACCOUNTING STANDARDS FAIR VALUE ACCOUNTING AND STANDARD-SETTING PROCESS

In its October 15 Declaration, the European Union Commission declared:

*“The Commission also considers that an in depth reflection is needed on fair value accounting, including possible procyclicality effects. The newly formed EFC group on procyclicality could be one avenue for taking forward this question expeditiously.*

*The Commission takes note that Member States want to have an in depth reflection on the standard-setting process.”*

This declaration suggests that, if accounting standards were not the cause of the financial turmoil obviously, the crisis was amplified by the effects of accounting standards, as their pro-cyclical nature was dramatically revealed on the occasion of the financial crisis and must therefore be studied and, if necessary, corrected.

**The purpose of this paper** is therefore:

(I) to describe as a starting point, the effects of fair value accounting, including “procyclicality”, on the accounts of companies and on the economy, showing that they can be observed in times of crisis as well as in normal times ;

(II) to identify, behind these findings, possible explanations linked to the assumptions underpinning fair value accounting standards, mostly the dominant role given to market transactions in order to determine value, and the explicit goal of standard-setters to pursue the route to a full fair value accounting system;

(III) to explore and recommend possible alternative accounting approaches and essentially, changes to the current set of rules, aimed at ensuring consistency of accounting standards with the economic activity of firms and measuring their actual performance in the medium and long term, as opposed to “instant market price” valuation; to demonstrate that this, together with the necessary consistency of accounting and prudential standards would better serve the economy as well as financial stability by being less pro-cyclical which is in the interest of investors as well as all other stakeholders;

(IV) finally to draw some conclusions about how to ensure that this alternative approach is indeed implemented efficiently by the standard setters, who therefore need to be more receptive to the needs of the economic actors .

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### **PRELIMINARY REMARKS**

1. The introduction of IFRS in the EU legal framework is not in question, despite frequent comments in this respect. IFRS have brought an opportunity to modernize and unify accounting standards in the EU. It has introduced, inter alia, standards that were lacking to account for complex financial instruments that had emerged precisely in the 1980's when IFRS were devised. And more transparency has been achieved at the same time.























